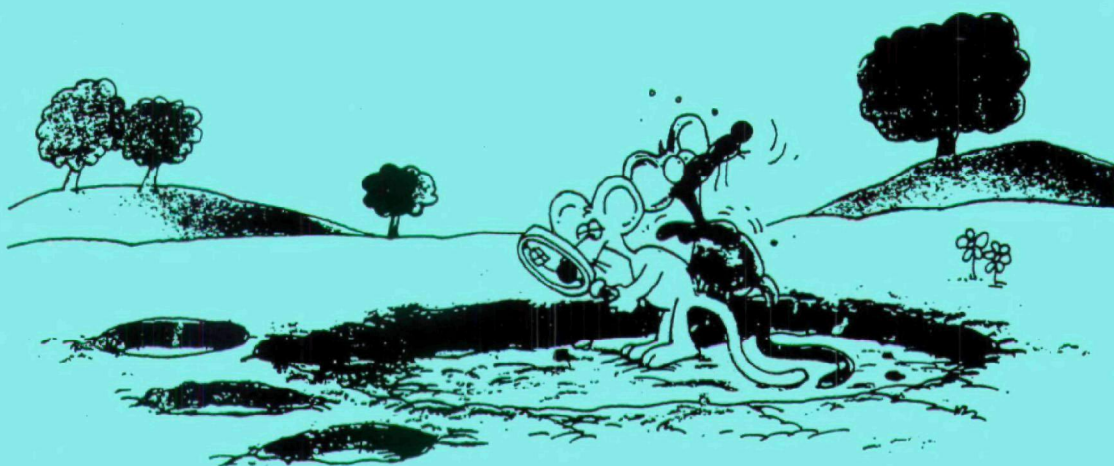




Office of the Inspector General

DETECTING AND PREVENTING FRAUD

An Awareness Course



Seminar for EPA OIG and IPA Auditors on Detection and Prevention of Fraud

Seminar Objective and Description

This seminar is designed to develop and enhance auditor awareness to the nature and characteristics of fraud and abuse in EPA funded projects and contracts. This seminar will review the professional standards concerning the auditors' role and responsibility for detecting fraud, identify types of fraud, their indicators, and describe specific audit steps to detect potential fraud. In addition, the seminar will examine several successfully prosecuted cases of fraud, showing how the fraud was detected and describe when and how auditors should refer suspected instances of fraud to the OIG Office of Investigations.

Fraud or abuse situations tend to be unique and any one method of detection will not be applicable to all situations that arise. This course is intended to develop an awareness that fraud and abuse may be present in EPA funded projects and contracts and that there are methods for detecting such fraud or abuse.

Some of the methodology involved in fraud or abuse detection will be discussed, but it is not the intent of this course to supply all the answers on "how to" detect fraud or abuse.

Fraud Indicators: An Overview

The Government auditor must be alert for possible instances of fraud. The best method of accomplishing this is to test for and identify fraud indicators.

A fraud indicator only means that a given situation is susceptible to fraudulent practices. It does not mean that fraud exists. The auditor's role is not to provide fraud (the intent to deceive the Government) but to refer potential instances of fraudulent practices to the appropriate investigative organization, if he or she believes that significant evidence indicating fraud has been found.

The review of EPA projects and contracts must be approached with an attitude of professional skepticism. There are no canned audit programs to find fraud indicators. When the auditor determines that the area to be reviewed is susceptible to fraud, he or she should include audit steps to cover the applicable fraud indicators. The auditor must think fraud indicators, look for them, and find them.

Schedule and Agenda for Two-Day Course

Day One

| | |
|---------------|-------------------------------------------------------------------------------|
| 8:30 - 9:00 | Introduction, Administrative Details, and Overall Course Objectives |
| 9:00 - 9:30 | Pretest |
| 9:30 - 10:00 | <u>Fraud: Definition, Characteristics, Motivation</u> |
| 10:00 - 10:15 | Break |
| 10:15 - 10:45 | <u>Auditors' Responsibilities: The Standards, GAO, AICPA, IIA</u> |
| 10:45 - 11:15 | <u>Documenting Indicators of Fraud</u> |
| 11:15 - 11:45 | <u>Making Referrals to the Office of Investigations</u> |
| 11:45 - 1:00 | Lunch |
| 1:00 - 2:00 | <u>General Indicators of Fraud and Assessing the Environment for Fraud</u> |
| 2:00 - 2:30 | Bid Rigging Videotape |
| 2:30 - 2:45 | Break |
| 2:45 - 3:45 | <u>Case Studies: Successful Prosecutions from EPA, How Fraud Was Detected</u> |
| 3:45 - 4:15 | <u>Civil and Administrative Actions</u> |

Day Two

| | |
|---------------|---------------------------------------------------------------------|
| 8:30 - 9:00 | Answers to pre-test |
| 9:00 - 10:00 | <u>Specific Types of Fraud in EPA Projects and their Indicators</u> |
| 10:00 - 10:15 | Break |
| 10:15 - 11:45 | Case Scenarios and Presentations of Referrals |
| 11:45 - 12:00 | Evaluation |

FRAUD PREVENTION AND DETECTION PRETEST

Multiple-Choice

1. As a monitor of the organization's control system, auditors should
 - a. Accept responsibility for the prevention and detection of fraud.
 - b. Identify all reasonably foreseeable risk areas in the organization and schedule reviews of those areas.
 - c. Be held responsible, as a professional, for extraordinary care rather than ordinary care.
 - d. Investigate any suspected fraud by interrogating suspects and witnesses.
 - e. All of the above.
2. The auditor has reason to believe a fraud is being committed in the bill paying unit of the controller's department. Which of the following actions best describes the way the auditor should proceed?
 - a. Immediately start an audit and interrogate suspected employees.
 - b. Inform the controller of suspicions and schedule an audit within 30 days.
 - c. Consider the present work load of the controller's department before scheduling an audit.
 - d. Inform the supervisor of the bill paying unit that an audit is being scheduled immediately.
 - e. None of the above.
3. The responsibilities of an internal audit department with respect to fraud include:
 - a. Detecting irregularities which would be disclosed by the application of appropriate auditing procedures.
 - b. Providing an entity with its primary defense against fraud.
 - c. Detecting irregularities that affect the financial statements.
 - d. Discovering irregularities that result from undetected weaknesses in the system of internal control.
 - e. Both (b) and (d) above.
4. The auditor's responsibility for fraud detection is to:
 - a. Conduct the audit with due professional care and skill.
 - b. Develop each audit program with the objective of fraud detection.
 - c. Assure that EDP controls will detect fraud.
 - d. Provide periodic assurance to management that fraud will be promptly detected.
 - e. Provide a report to management indicating the extent that fraud has occurred.
5. On the basis of the preliminary review, the auditors for a Federal agency have reason to believe that irregularities exist in the cash disbursement function. The auditors should proceed by:
 - a. Performing an extensive investigation to determine the existence and extent of the suspected irregularities.
 - b. Notifying the appropriate law enforcement agency.
 - c. Informing the appropriate authorities within the agency.
 - d. Strengthening internal controls within the cash disbursement function.
6. The auditor's usual approach to fraud minimization is to recommend that.
 - a. Employees who handle liquid assets be bonded.
 - b. Strong internal controls be implemented and are operative.
 - c. Competent employees be hired.
 - d. Employees not be given access to physical assets.
7. You have just received an anonymous letter containing allegations that certain employees are diverting readily repairable items to the scrap yard and later purchasing these materials at scrap prices. What is the first action you should take?
 - a. Advise the Office of Investigations.
 - b. Review scrap sales records.
 - c. Review material disposition records.
 - d. Interview employees performing the material review and disposition function.

8. The cashier of Brown Company covered a shortage in the cash working fund with cash obtained on December 31 from a local bank by cashing an unrecorded check drawn on the company's New York bank. The auditor would discover this manipulation by:
 - a. Preparing independent bank reconciliations as of December 31.
 - b. Investigating items returned with the December 31 cutoff bank statements.
 - c. Preparing an intracompany bank transfer schedule for several days preceding and following December 31.
 - d. Comparing the authenticated deposit ticket details with entries in the cash receipt books.
9. Auditors would consider embezzlement a likely possibility when:
 - a. Employees in the finance department are working overtime regularly.
 - b. Production reports are found to contain inaccurate descriptions of work completed.
 - c. Vacations are not taken by employees in the accounting and cashiering functions.
 - d. Allowances for doubtful accounts are found to be inadequate.
10. An employee in the accounts payable department has been authorizing duplicate payments on some invoices and then intercepting the second check for personal use. A control to deter such duplicate payments would be to:
 - a. Have the person who maintains the cash disbursements records issue the check.
 - b. Have the authorized check signer "cancel" supporting documentation when the check is signed.
 - c. Keep blank checks under lock and key.
 - d. Maintain a segregation of duties between the cash payments function and the cash receipts function.
11. Gray and Green are engaged in perpetrating a fraud against their employer. Gray diverts a customer's check to the bank account of a company that is controlled by Gray, and Green writes off the customer's account receivable as uncollectible. What control technique would tend to deter such a practice?
 - a. Periodic confirmation of customer accounts by internal auditors.
 - b. Adoption of a procedures manual specifying adequate documentation and records.
 - c. Hiring only competent personnel.
 - d. Reconciliation of accounts receivable details to accounts receivable control account.
12. What is the auditor's responsibility with respect to fraud?
 - a. To give management absolute assurance that irregularities do not exist.
 - b. To evaluate adequacy and effectiveness of controls designed to prevent fraud.
 - c. To report suspected frauds to regulatory agencies.
 - d. To prepare written policies concerning conflicts of interest, hiring practices, and prosecution of wrongdoers.
13. Which of the following is most likely to alert an auditor to the possibility of fraud?
 - a. The same person normally delivers the bank deposit.
 - b. An accounts receivable clerk took only 2 weeks of a 3-week vacation and was compensated for the third week.
 - c. Many noncash credits to receivables have been posted.
 - d. The responsibility for preparing bank reconciliations is not rotated among different employees.
14. An auditor found that a purchasing agent, in collusion with a vendor, had defrauded the company by purchasing excessive quantities and unnecessary items. Which of the following control measures would be most effective in preventing such fraud?
 - a. Requiring purchases from the approved vendor list.
 - b. Maintaining multiple vendor sources.
 - c. Specifying that all purchases be based on requisitions approved by responsible persons.
 - d. Using priced purchase orders.

15. Which of the following controls over the issuance of inventory from a warehouse would most likely detect theft or fraud?
 - a. Using prenumbered forms for issuance of merchandise from the warehouse.
 - b. Requiring two authorized signatures on all forms for issuance of merchandise from the warehouse.
 - c. Comparing counts of assets at the warehouse with externally maintained records.
 - d. Cancelling material requisitions subsequent to the issuance of merchandise.
16. After auditors have concluded their audit in which a fraud is suspected, what additional action should the auditors take?
 - a. Inform the appropriate authorities within the organization that a fraud is suspected.
 - b. Based on the employee's willingness to make restitution, determine whether prosecution should take place.
 - c. Reappraise internal control to determine what aspects of the operational and control design made the fraud possible.
 - d. Use proportional analysis to determine the reasonableness of certain account relationships.
17. Current thinking relative to the concept of materiality as applicable to the reporting of illegal acts is that materiality is:
 - a. An agreed percentage of the total value of the resources exposed to illegal activities.
 - b. Not a determining factor in that all illegal acts are to be reported by the auditor.
 - c. Normally considered as an amount in excess of a stated parameter.
 - d. Based on subjective determination related to the circumstances of the case.
 - e. Related to the type of illegal act.
18. Of the procedures listed, which is the most likely to detect kiting?
 - a. Compare the detail of cash receipts (log listings) to the cash receipts journal, accounts receivable postings, and deposit slips.
 - b. Investigate checks that have been outstanding for long periods.
 - c. Account for bank transfers made during a few days before and after selected dates.
 - d. Confirm account receivable balances as of a cutoff date.
 - e. Count cash on hand.
19. One driver for a linen supply service collects cash from customers upon delivery and intentionally fails to record and turn over to the company certain amounts of cash received. What audit procedure would the auditor use to obtain assurance that such losses are being detected?
 - a. Review driver's daily delivery reports.
 - b. For each driver, reconcile daily the total billings for clean linens shipped with cash received and clean linens returned.
 - c. Have an auditor periodically accompany the drivers on selected runs.
 - d. Confirm deliveries periodically with selected customers.
 - e. Undertake compliance testing with respect to daily reconciliation of linens shipped, cash received, and clean linens returned.
20. Which of the following payroll irregularities would most likely be discovered by a surprise observation of a payroll distribution?
 - a. An employee has access to the payroll computer program and raises his hourly salary by 50 percent.
 - b. Improper deductions are made from several employees' checks.
 - c. Checks for terminated employees continue to be prepared.
 - d. An employee pads his payroll by having a friend punch time cards on days he is absent and working on a second job.
 - e. Premium pay for night-shift work is being paid to employees working the day shift.

SECTION 1
GENERAL INFORMATION
ABOUT FRAUD

SECTION I. Fraud: Definition, Characteristics, Motivation

Objectives

This section is designed to define what fraud is and differentiate it from waste and mismanagement. When we think of fraud, waste, and mismanagement, we often get confused because they are all similar. However, fraud usually represents illegal acts opposed to mistakes, errors in judgment, carelessness, or dereliction of duty. This section also describes the different types of fraud, some of the motives to commit fraud, and why fraud is so difficult to detect. It is important to know what fraud or possible fraud is so that we can perform the proper tests and make the appropriate referral. Since fraud is a violation of the law it often has a more severe impact than waste or mismanagement and is usually resolved through criminal and/or civil action. By being able to recognize fraud we can significantly increase our potency as professionals.

A. FRAUD

A ~~false~~ representation or concealment of a material fact to induce someone to part with something of value.

B. ELEMENTS OF FRAUD

1. False representation
2. Knowledge of falsity
3. Intent
4. Reliance
5. Injury (\$damage)

C. INTENT IS A STATE OF MIND

1. Difficult to prove
2. Evidence may not be present

D. FALSE CLAIM

All fraudulent attempts to cause the Government to pay out sums of money.

E. ELEMENTS OF A FALSE CLAIM

1. False representation
2. Knowledge of falsity
3. Intent to mislead
4. Tender of claim to Government

F. MODEL OF WHITE-COLLAR CRIME

1. Situational pressures
2. Opportunities
3. Personal characteristics

G. MOTIVES

1. Financial need
2. Greed
3. Hide Incompetence
4. Resentment
5. Peer group pressure

H. FRAUD TO BENEFIT THE ORGANIZATION

1. Claims for fictitious work, equipment, or services.
2. Improper payments such as bribes, kickbacks, or illegal political contributions.
3. Improper related party transactions.
4. Failure to record or document claims for work, equipment, or services.
5. Under bidding and using change orders.
6. Circumvent competition by bid rigging or collusive activity.
7. Prohibited business practices in violation of Government laws and regulations.

I. FRAUD DETRIMENT TO THE ORGANIZATION

1. Acceptance of bribes or kickbacks
2. Embezzlement
3. Concealment of events or data
4. Claims for goods or services not provided to the organization

J. SOME FRAUDS ARE IMPOSSIBLE TO DETECT THROUGH NORMAL AUDIT ROUTINES

1. Collusion
2. Forgery
3. Unrecorded transactions

K. FRAUD INDICATORS

A composite of small events which, put together, point to a possible pattern of deception.

L. BASIC CONCEPTS FOR FRAUD PREVENTION

1. No activity is immune from fraud-waste-abuse
2. Insist on the adherence to standard procedures and controls
3. Use trend reports to monitor operations
4. Use independent sources for information
5. Carefully identify the sensitive areas subject to fraud
6. Maintain effective system for administrative and personnel actions to combat fraud
7. Refer criminals for investigation and prosecution

GENERIC CHARACTERISTICS OF ILLEGAL ACTS

| <u>CONTROL ENVIRONMENT</u> | <u>OPPORTUNITY</u> | <u>INDICATOR</u> |
|-----------------------------------------------------------------------------|--------------------|------------------|
| 1. ONE PERSON IN CONTROL | X | |
| 2. NO SEPARATION OF DUTIES | X | |
| 3. PERSONS LIVING BEYOND MEANS | | X |
| 4. MISSING OR INCOMPLETE INTERNAL CONTROLS | X | |
| 5. NO PRIOR AUDIT | X | |
| 6. DECENTRALIZED MANAGEMENT WITHOUT MONITORSHIP | X | |
| 7. EVASIVE RESPONSES TO AUDIT INQUIRIES | | X |
| 8. EXCESSIVE ATTEMPTS TO DELAY AUDIT | | X |
| 9. LIMITATIONS ON SCOPE OF AUDIT | | X |
| 10. MANAGEMENT READILY WILLING TO ADMIT TO MISMANAGEMENT IN SERIOUS MATTERS | | X |
| 11. HIGH TURNOVER OF SENIOR PERSONNEL | X | |
| 12. RECENT CHANGES IN WORKING PROCEDURES | X | |
| 13. ATTEMPTS TO TERMINATE AUDIT | | X |
| 14. UNUSUAL CONCERN WITH AUDIT DOCUMENTATION | | X |
| 15. MANAGEMENT TOO COOPERATIVE | X | |
| 16. CONSPICUOUS CHARITY | | X |
| 17. SUSPICIOUS TRENDS | | X |
| 18. UNUSUAL BEHAVIOR | X | |
| 19. RECENT MONEY PROBLEMS | X | |

GENERIC CHARACTERISTICS OF ILLEGAL ACTS

| <u>ACCOUNTING SYSTEM</u> | <u>OPPORTUNITY</u> | <u>INDICATOR</u> |
|------------------------------------------------|--------------------|------------------|
| 1. MANY CONTENTIONS ACCOUNTING ISSUES | X | |
| 2. EXTENSIVE JUDGMENT INVOLVED IN TOTALS | X | |
| 3. DIFFICULT TO AUDIT TRANSACTIONS | X | |
| 4. INADEQUATE OR MISSING DOCUMENTATION | | X |
| 5. UNUSUAL, UNEXPLAINED ENTRIES | | X |
| 6. PAYMENTS FOR CASH, UNSPECIFIED REASONS | | X |
| 7. INORDINATELY LARGE TRANSACTIONS | X | |
| 8. SUPPORTING RECORDS NOT PROMPTLY PRODUCED | | X |
| 9. PHOTOCOPIED ORIGINAL RECORDS ON FILE | | X |
| 10. UNACCEPTABLY LARGE ERROR RATES | X | |
| 11. PROFITABILITY OUT OF LINE WITH INDUSTRY | | X |
| 12. QUESTIONABLE OWNERSHIP | | X |
| 13. MIX OF GOVERNMENT AND COMMERCIAL CONTRACTS | X | |
| 14. LOSSES ON COMMERCIAL CONTRACTS | | X |
| 15. MIX OF FIXED PRICE AND COST TYPE CONTRACTS | X | |
| 16. LOW NUMBER OF BIDDERS | X | |

GENERIC CHARACTERISTICS OF ILLEGAL ACTS

| <u>CONTROL PROCEDURES</u> | <u>OPPORTUNITY</u> | <u>INDICATOR</u> |
|-----------------------------------------------------|--------------------|------------------|
| 1. ALTERED/SUSPECT RECORDS | | X |
| 2. UNAUTHORIZED TRANSACTIONS | | X |
| 3. NONSERIAL NUMBERED TRANSACTIONS | | X |
| 4. UNAUTHORIZED PERSONNEL WITH ACCESS | X | |
| 5. INVENTORIES NOT RECONCILED | | X |
| 6. LACK OF OPERATING PROCEDURES | X | |
| 7. ASSETS SUSCEPTIBLE TO MISMANAGEMENT | X | |
| 8. POOR TIMEKEEPING SYSTEM | X | |
| 9. MANY CRISIS CONDITIONS | | X |
| 10. UNCORRECTED PROBLEMS REPORTED IN PRIOR AUDIT | X | |
| 11. NO INDEPENDENT CHECKS | | X |

SECTION 2
AUDITORS'
RESPONSIBILITIES

SECTION II. Auditors' Responsibilities: GAO and AICPA Standards.

Objectives

This section highlights portions of the professional auditing standards dealing with auditors' responsibility for identifying and reporting fraud and illegal acts. These standards are generally applicable to EPA auditors and to auditors who perform work for EPA and are recognized throughout the auditing profession. This section describes how far auditors should go and what they should do to identify and respond to fraud. This section also describes the expectations and limitations of professional audit work in regards to detection fraud.

A. PROFESSIONAL STANDARDS FOR AUDITORS

1. United States General Accounting Office (GAO) Government Auditing Standards: Standards for Audit of Governmental Organizations, Programs, Activities, and Functions relevant to compliance with applicable laws and regulations:

- o Chapter 4—Field Work Standards for Financial Audits.
- o Chapter 5—Reporting Standards for Financial Audits.
- o Chapter 6—Field Work Standards for Performance Audits.
- o Chapter 7—Reporting Standards for Performance Audits.
 - Legal and Regulatory Requirements:
 - Assessment of Compliance
 - Errors, Irregularities, and Illegal Acts
 - Due Care Concerning Illegal Acts
 - Internal Control

STANDARDS ON AUDITORS' RESPONSIBILITY FOR FINANCIAL & PERFORMANCE AUDITS

WHAT THE YELLOWBOOK SAYS

- Identify those major laws and regulations that apply to the entity to be audited/evaluated and that are relevant to the assignment objectives.
- Assess the risk that noncompliance with these laws and regulations could significantly affect the program operations of financial statements being audited.
- Assess the adequacy of internal controls for ensuring compliance and for detecting instances of noncompliance with applicable laws and regulations as determined by the risk analysis.
- Design work steps to reasonably assure (1) the entity's compliance with relevant laws and regulations, and (2) the detection of error, irregularities, abuse, or illegal acts that could significantly affect assignment objectives.
- Exercise appropriate precautions relating to illegal acts so as not to interfere with potential future investigations and/or legal proceedings.
- Promptly prepare an audit/evaluation report which includes all material instances of noncompliance and illegal acts that could result in prosecution.

Additionally, for financial audits, auditors must promptly prepare a written report on compliance that contains a statement of positive assurance on items tested for compliance and negative assurance on those items not listed.

2. American Institute of Certified Public Accountants (AICPA) Generally Accepted Auditing Standards relevant to compliance with applicable laws and regulations: Nine "Expectation Gap" Standards.

- o SAS No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities.
- o SAS No. 54, Illegal Acts by Clients.
- o SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit.
- o SAS No. 56, Analytical Procedures.
- o SAS No. 57, Auditing Accounting Estimates.
- o SAS No. 58, Reports on Audited Financial Statements.
- o SAS No. 59, The Auditors Consideration of an Entity's Ability to Continue as a Going Concern.
- o SAS No. 60, Communication of Internal Control Structure Related to Matters Noted in an Audit.
- o SAS No. 61, Communication with Audit Committee.

Statements on Auditing Standards 53

The Auditor's Responsibility to Detect and Report Errors and Irregularities in an audit of financial statements.

Errors refer to unintentional misstatements or omissions of amounts or disclosures in financial statements.

The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement.

Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting material errors and irregularities.

The auditor is responsible for informing the audit committee of equivalent of all but inconsequential irregularities.

Statements on Auditing Standards 54

Illegal Acts by Clients

This statement describes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements.

Illegal acts refer to violations of laws or governmental regulations. Whether an act is illegal, is a determination beyond the auditors's professional competence. However, whether an act is illegal would be based on the advise of an informed expert qualified to practice law or may have to await final determination by a court of law.

The auditor's responsibility with respect to detecting, and reporting illegal acts is to apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

Statements on Auditing Standards 55

Consideration of the Internal Control Structure in a Financial Statement Audit

The statement on auditing standards requires the auditor to have an understanding of the control environment, the accounting system, and the control procedures, and (1) identify types of potential mistakes, (2) consider factors that may affect the risk of material misstatement, and, (3) design substantive tests. The control environment focuses on the philosophy and operating style, organizational structure, and management's control methods. The accounting system maintains documentation of transactions, and timely reporting of transaction. While the control procedures establishes proper authorization of transactions, control of accounting documents, safeguard of assets, segregation of duties, and independent checks.

Characteristics of illegal acts includes observing internal control weakness, personal behavior, relationship, or deviation in recordkeeping that raises skepticism about the fidelity of a function in which there is an opportunity for illegal acts.

**B. EXTENSIVENESS OF STEPS TO DETERMINE
NONCOMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS**

Auditing standards require that a determination be made whether activities or financial statements being audited or evaluated are in compliance with relevant laws and regulations. Auditors and evaluators must determine when and to what extent they must test for noncompliance with applicable laws and regulations to detect errors, irregularities, abuse, or illegal acts. Generally, the greater the materiality, significance, and sensitivity, the greater the degree of required compliance testing.

Depending on an assignment's objectives and the results of any risk and internal control assessments, auditors and evaluators may: (1) expand the assignment's scope, (2) spin off a separate assignment, or (3) refer suspected noncompliance to a third party. OIG Manual Chapter 122—Compliance With Laws and Regulations establishes policy and procedures for OIG auditors' and evaluators' use in assessing compliance with laws and regulations in accordance with Government Auditing Standards (1988 revision).

Specifically, OIG Manual Chapter 122 provides OIG auditors and evaluators guidance in deciding:

- o when to test for compliance.
- o how to identify applicable laws and regulations.
- o how to evaluate the likelihood that noncompliance could occur and not be detected or prevented by internal controls.
- o how much testing to do.
- o how to deal with and report suspected or actual illegal acts.

EXAMPLE OF STEPS AND QUESTIONS TO CONSIDER IN AUDIT PLANNING, FIELD WORK AND REPORTING

Compliance with Laws and Regulations

- Determining whether grants were awarded in accordance with applicable government regulations.
- Determining whether justification for noncompetitive contract awards met regulatory requirements.
- examining and testing collections of revenues to verify that they were recorded, collected and deposited in the U.S. Treasury.
- Testing, by independent confirmation, of assets, income, employees and hours charged, claims and expenses.
- Examining travel expenses of employees to confirm that reimbursement was in accordance with regulations and that travel was for official business.
- Determine whether contractors are charging unallowable costs to contracts (e.g., advertising, entertainment)

- Determining whether contractors are using government owned materials and equipment on nongovernment work, and if the government is getting the materials and equipment back.

- Examining investigative reports, suspension and debarment reports, or payment of fines or penalties.

- Examining justifications and authorizations for large payments for unspecified services to consultants, affiliates of employees.

- Examining supporting documents, such as invoices, canceled checks, and agreements and comparing with accounting records.

- Confirming significant information with other parties or intermediaries, such as banks, lawyers, and other government records (deeds, tax or FICA)

Risk Analysis

- Do incentives exist for program manager, participants or beneficiaries to commit illegalities?

- Are decisions made primarily by a single person?

- Do applicable laws and regulations contain adequate specificity or are they too vague?

- Is cash or other assets susceptible to improper conversion?

- Has management turnover been high?

- Is the organization decentralized without adequate monitoring?

- Are test results independently verified?

- Is there a repeated pattern of problems or complaints?

Assessment of Internal Controls

- Are there policies and procedures in place and are they followed?

- Is there separation of duties?

- Is there documentation of transactions and other significant events?

- Is there authorization and execution of transactions and other significant events by appropriate persons.

- Are items of value, including information, safeguarded?

C. DEFINITIONS

Abuse- Furnishing excessive services to beneficiaries or performing what may be considered improper practices, non of which involves noncompliance with laws and regulations

Errors- Unintentional misstatements or omissions of amounts or disclosure in financial statements.

Illegal Acts- Failure to follow requirements of laws or implementing regulations.

Irregularities- Intentional misstatements or omissions of amounts or disclosures in financial statements.

Materiality- The magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances and qualitative and quantitative considerations, makes it probable that the judgment of reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Significance- The importance, in relation to the audit/evaluation objectives, of an item, event, information, problem or matter the auditor/evaluator identifies.

Auditors/Evaluators always should perform all work with an attitude of professional skepticism!

Field Work Standards for Performance Audits

Legal and Regulatory Requirements

Auditors should design the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives.

- 40 When audit steps and procedures indicate that abuse or illegal acts have or may have occurred, the auditor needs to determine the extent to which these acts significantly affect the audit results.
- 41 Detecting noncompliance resulting from illegal acts is generally difficult. Doing so commonly requires special steps, and auditors are expected to devise and apply such steps as may be effective. Because a sound internal control structure can be effective in ensuring compliance, an assessment of the control structure is generally useful.
- 42 In all performance audits:

Auditors should be alert to situations or transactions that could be indicative of abuse or illegal acts.
- 43 When information comes to the auditor's attention (through audit procedures, tips, or other means) indicating that abuse or illegal acts may have occurred, the auditor should consider the potential impact of these acts on the audit results. If these acts could significantly affect the audit results, the auditor should extend the audit steps and procedures, as necessary (a) to determine whether the acts occurred and (b) if so, to determine the extent to which these acts significantly affect the audit results.
- 46. Circumstances may exist in which laws, regulations or policy require auditors to promptly report indications of illegal acts to law enforcement or investigatory authorities before extending audit steps and procedures. The auditor may also be required to withdraw from, or defer further work on, the audit or a portion of the audit in order not to interfere with an investigation. However, the auditor should consider whether this would restrict the completion of the remaining portion of the audit or interfere with the auditor's ability to form objective opinions and conclusions. If it restricts or interferes, the auditor should terminate the audit or discontinue further action until completion of the investigation (See reporting requirements in chapter 7)
- 47 Most auditors are not trained to conduct investigations of certain types of illegal acts which are the responsibility of the investigator or law enforcement authorities. However, auditors are responsible for being aware of the characteristics and types of vulnerabilities and potential illegal acts associated with the area being audited in order to be able to identify indications that these acts may have occurred.
- 48. An audit made in accordance with the standards in this statement will not guarantee the discovery of all abuse or illegal acts. Nor does the subsequent discovery of abuse or illegal acts committed during the audit period necessarily mean the auditors' performance was inadequate, provided the audit was made in accordance with the standards in this statement.

Due Care Concerning Illegal Acts

- 44 When an audit is conducted under contract and the contract does not permit the auditor to unilaterally extend steps and procedures, the auditor should obtain written approval to perform the necessary additional work. If such approval is not given to the auditor, a scope impairment generally exists which should be stated in the auditor's report.
- 45 Auditors should exercise due professional care and caution in pursuing indications of illegal acts so as not to interfere with potential future investigations and/or legal proceedings. Due care would include consulting appropriate legal counsel and/or the applicable law enforcement organization, where appropriate, before proceeding.

Reporting Standards for Performance Audits

Compliance With Laws and Regulations

33. The report should include all significant instances of noncompliance and abuse and all indications or instances of illegal acts that could result in criminal prosecution that were found during or in connection with the audit.¹

Noncompliance

34. The auditors' report should include all significant instances of noncompliance found during or in connection with the audit, even those not resulting in a legal liability of the entity. All instances of illegal acts that could result in the entity, or an official or employee of the entity, being subject to criminal prosecution should also be reported.

Abuse and Illegal Acts

36. If, during an audit or in connection with an audit of a government entity, external government auditors become aware of abuse or illegal acts or indications of such acts that could affect the government entity, they should promptly report to the top official of that entity. The auditor should also consider reporting to the appropriate oversight body. If the top official is believed to be a party to such acts or otherwise implicated, the auditor should in all cases report to the appropriate oversight body. If the acts involve funds received from other government entities, the auditors should also promptly report to the proper officials, including the audit officials, of those entities.
39. Nongovernment audit organizations conducting government audits will discharge their responsibilities for reporting abuse or illegal acts or indications of such acts found during or in connection with an audit by promptly reporting to the top official of the entity arranging for the audit.
42. Abuse or illegal acts or indications of such acts that auditors become aware of should be covered in a written report and submitted in accordance with the preceding paragraphs. Such acts may be covered in a separate report if including them in the overall report would compromise investigative or legal proceedings or otherwise preclude the report from being released to the public. Auditors generally should not release information or reports containing information on potential illegal acts that could result in the entity, or officer or employee of the entity, being subjected to criminal prosecution, or reports with references that such acts were omitted from reports, without consulting with appropriate legal counsel, since this could interfere with legal processes or subject the implicated individuals to undue publicity, or might subject the auditor to potential legal action.

Field Work Standards for Financial Audits

Errors, Irregularities and Illegal Acts

The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of financial related audits.

The auditor should also be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of financial related audits.

14. In fulfilling the above requirements relating to errors, irregularities, and illegal acts, the auditor should follow the guidance contained in the AICPA standards entitled The Auditor's Responsibility to Detect and Report Errors and Irregularities and Illegal Acts By Clients.

Due Care Concerning Illegal Acts

15. Auditors should exercise due professional care and caution in extending audit steps and procedures relative to illegal acts so as not to interfere with potential future investigations and/or legal proceedings

Due care would include consulting appropriate legal counsel and/or the applicable law enforcement organizations, where appropriate, to determine the audit steps and procedures to be followed.

16. Circumstances may exist where laws, regulations, or policies require the auditor to promptly report indications of certain types of illegal acts to law enforcement or investigatory authorities before extending audit steps and procedures. The auditor may also be required to withdraw from or defer further work on the audit or a portion of the audit in order not to interfere with an investigation. However, the auditor should consider whether the above circumstances would restrict the completion of the remaining portion of the audit or interfere with the auditor's ability to form objective opinions and conclusions. If it restricts or interferes, the auditor should consider discontinuing further action until completion of the investigation, or terminate the audit
17. Most auditors are not trained to conduct investigations of certain types of illegal acts which are the responsibility of the investigator or law enforcement authorities. However, auditors are responsible for being aware of the characteristics and types of illegal expenditures and acts associated with the area being audited to be able to identify indications that these acts may have occurred.
18. An audit made in accordance with the standards in this statement will not guarantee the discovery of all illegal acts or contingent liabilities resulting from noncompliance. Nor does the subsequent discovery of illegal acts committed during the audit period necessarily mean that the auditor's performance was inadequate provided the audit was made in accordance with these standards

Reporting Standards for Financial Audits

Illegal Acts

10. If, during or in connection with an audit of a government entity, external government auditors become aware of illegal acts or indications of such acts affecting the government entity, they should promptly report to the top official of that entity. The auditor should also consider reporting to the appropriate oversight body. If the top official is believed to be a party to such acts or otherwise implicated, the auditor should in all cases report to the appropriate oversight body. If the acts involve funds received from other government entities, auditors should also promptly report to the proper officials, including the audit officials, of those entities.

16. Illegal acts or indications of such acts that auditors become aware of need not be included in the required audit reports, but may be covered in a separate written report and submitted in accordance with the preceding paragraphs, thus permitting the required report or reports to be released. However, auditors generally should not release information or reports containing information on such acts or reports with references that such acts were omitted from reports, without consulting with appropriate legal counsel, since this release could interfere with legal processes, subject the implicated individuals to undue publicity, or subject the auditor to potential legal action.

SECTION 3
DOCUMENTING INDICATORS
OF FRAUD

SECTION III. Documenting Indicators of Fraud, Audits Techniques
and Altered Documents

Objectives

This section describes what types of information should be obtained to help identify and document indicators of possible fraud along with a review of those audit techniques used to collect audit evidence. This section also will discuss the need to examine seemingly good audit evidence and support for the possibility that it has been altered. Auditors need to look beyond the usual documentation to determine the authenticity of that documentation. A sound audit trail may be composed of altered or false documents.

A. AUDIT TECHNIQUES

1. Analyze
2. Scrutinize
3. Compare
4. Interview
5. Confirm
6. Observe
7. Trend Analysis

B. ANALYZE

Break a ledger balance into its component parts.

C. SCRUTINIZE

Review documents used to arrive at the figure in your analysis.

D. COMPARE

Evaluate different sources for accuracy or proper recording.

E. INTERVIEW

Through a meeting or conversation, obtain information or facts from another person.

F. CONFIRMATION

Corroboration by an outside entity of the amount, as of a certain date, owed them by the audited party or the amount which they owe the audited party.

G. OBSERVE

Watch with attention so as to see or learn something.

H. TREND ANALYSIS

Related items in the financial statements should change together over time.

I. AUDIT EVIDENCE

1. Audit evidence obtained from an independent source provides greater assurance of reliability than that secured from the auditee organization.
2. Audit evidence developed under a good system of internal control is more likely to be reliable than that obtained where such control is weak or unsatisfactory.
3. Evidence obtained by the auditor through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.
4. Original documents are more reliable than copies.

J. SOURCES OF INFORMATION

1. Deposit slips
2. Loan documents
3. Personal financial statements
4. Deposit accounts
5. Signature cards
6. Endorsed and processed checks

K. CHECKS AND RECONCILIATIONS

1. Names
2. Dates
3. Endorsements
4. Authorizations
5. Purpose
6. Number
7. Federal Reserve Bank notation

Exhibit

SECTION III. DOCUMENTING INDICATORS

Techniques for Obtaining Evidence in Contract Fraud Cases

- I: Voluntary cooperation of contractor
 - A. Access to records beyond scope of contract right
 - B. Access to employees on company time
 - C. Access to premises
- II. Compulsory interview of Federal employees
- III. Contract clauses
 - A. Inspection clause U.S. v Hartley 678 F2d 961 (11th Cir. 1982)
 - B. Audit clause ZAP v U.S. 328 U.S. 624 (1946) (10 U.S.C. 2276)
- IV. IG Subpoenas
 - A. Standard - reasonably related to a legitimate inquiry and not burdensome
 - B. Official curiosity
 - C. Procedures for obtaining subpoenas
 - D. Upside
 - 1. Contractor records not covered by contract
 - 2. 3rd party records
 - 3. Personal records of contractor and Government employees
 - 4. Bank records
 - E. Downside
 - 1. Timeliness
 - 2. Destruction of records
- V. Outside Sources
 - A. 3rd party witness interviews
 - B. Former employees

L. ALTERED DOCUMENTS

1. Document substitution
aka spurious documents
2. Alterations

M. ALTERED DOCUMENTS: WHAT TO CHECK

1. Delivery addresses
2. Amounts
3. Items and specifications
4. Authorizations
5. Invoice or order numbers
6. Actual checks and bank reconciliations
7. Endorsements

N. EXAMPLES OF ALTERATIONS

1. Disturbing the paper fibers by hand or by machine
 - overwriting
 - tracing
 - free hand simulation
 - information added with a typewriter

O. DOCUMENT SUBSTITUTION

1. Fictitious checks or invoices
2. Fictitious signatures
3. Repetitious second endorsement
4. Photocopy different from original, when offered in place of the original

Exhibit

QUESTIONED DOCUMENTS

✓

The following is an excerpt from the chapter on "Document Consciousness" in the book, Evidential Documents, by James V. P. Conway (1959, Charles C. Thomas, Publisher).

"There follow a few general questions pertinent to every document and a number of specific questions relevant to a few documents. It has been observed repeatedly that the most frequently overlooked of these inquiries are those which should be the most obvious. These questions are in no sense all inclusive of considerations which merit study but they provide a basis for the thoughtful, reasoning approach to evidential documents.

1. When and where did the document, say a check, deed, or note first appear?
2. By whom was it presented? What is his interest? His reputation?
3. Is the document's very existence suspicious? Doth it protest too much the cause it was designed to serve?
4. What did the presentor say about the document at the time he presented it? Later? Why discrepancies, if there be such?
5. Is the document in the same condition now as when it was first presented? Have you so assumed or do really know?
6. By whom does the document purport to have been drawn or prepared?
7. Have you erroneously assumed that the date, body, and signature were written by the same person?

8. If an endorsement, have you assumed that the signature and address were written by same person? Can you establish the correctness of your assumption?
9. What do the executors of the document have to say about their participation? Did they indulge complete details or were they glossed over? Did you err by permitting a collaborated story to be given by several interested parties?
10. Is the date of the document logical to its content? If a letter, did the author betray himself by improper tense of verbs or the "forecasting" of events inconsistent with the document's date?
11. Is the date of the document consistent with the movements of the principal? Have you considered hospitalization, injuries, vacations, business trips?
12. Was the document presented timely in the light of its date? If not, where has it been, and why?
13. Are the writing media, pen, pencil, paper, and ink, consistent with the document's date and the representations made for it by its proponents? With the habits of its purported author at the time in question? With his physical and mental condition at that time?
14. Have you identified the author and signer through his or their handwriting or have you merely assumed writing authenticity? Have you acquired technically adequate, provable, and legally admissible exemplars?
15. Have you examined companion documents of proper vintage to ascertain their agreement or otherwise with the habits reflected in the evidential documents?
16. Do you recognize that authentic companion documents provide a much more reliable mode of proof than self-serving, accusatory, or otherwise partisan statements by interested principles?

17. Have you reconciled disagreements between the evidential document and companion documents? Is your reconciliation reasonable in itself and consistent with the representations made by the proponents of the document?
18. Are there witnesses to the preparation, execution, or presentation of the document? What is his or their interest? Reputation?
19. Have the witnesses supplied complete details as to time, place, and circumstances? If not, why not? Do they remember not wisely but too well all the self-serving details?
20. Are the witnesses certain they could not be confused about a similar document? A similar transaction? Was your consideration of these points cursory? Partisan? Presumptive?
21. Does the document, for example a check, have a number? Should it have one in view of the habits of its purported author?
22. Is the number of the document, say a check or invoice, in proper sequence by comparison with companion documents of the same vintage, or has it clearly been postdated or antedated?
23. Have you too readily accepted a hotel or motel registration as an alibi? Does its time and does its number coincide with other registrations of the same date? Is it supported by correct accounting records? Is its format, including printing, in agreement with companion registrations?
24. Does the document bear any indication or suggestion of an erasure or alteration? Is the suspect area contiguous to or does it embody a key part of the document?
25. If a photostat, where is the original? Is presentation of the photostat rather than the original suspicious in itself?
26. If a photostat, why is the original unavailable to you, if it is? If a court order or permission of a third party is necessary for inspection of the original, have you ascertained complete details for timely action?

27. Have you considered and accounted for ALL the handwriting, initials, addresses, telephone numbers, identification data, stamped impressions, etc., on the questioned check?
28. Have you been wasting your time, or do you have men on your staff who have been dissipating their time, comparing check endorsements with the writing of suspected forgers, without first ascertaining that parts of these endorsements were not written by the forger at all, but represent the handwriting of the second endorser or his agent?
29. Have you dissipated hours of investigative time, reached erroneous conclusions, and perhaps confused your document examiner, by comparing the signatures or issuing particulars on forged checks, when your problem involved tracings and simulations?
30. Have you issued circulars which advertised all too clearly that your department did not understand how responsibility must be established in cases involving tracings and studied simulations?
31. Does the document purport to have been written or signed with a ball point pen prior to 1945.
32. Does the document purport to have been written or signed with a liquid lead pencil prior to 1955.
33. Does the typewritten document contain a short center "W" or "w" and is it dated prior to 1935.
34. Is the document, perhaps a will, hiding behind deceased witnesses? Have you examined their signatures of comparable date, or have you assumed somewhat automatically that the witnesses' signatures are authentic?
35. Is the document ceremoniously hiding behind a notarial or other seal of no real identifying value?

36. Have you established that the notary or other public official physically witnessed execution of a document, so purporting? If so, did he correctly identify the signer?
37. Is the seal on the document legible and authentic? Have you compared it with admittedly authentic seals?
38. Have you assumed that the signature of the notary or other public official was authentic? Have you compared companion signatures? Are the latter and related records for the date in issue maintained with similar pen and ink?
39. If a printed form, have you checked its origin? Have you compared similar and companion forms of corresponding date?
40. Is the location of an obliterated or eradicated area of the document highly suspicious in itself? Have you sought specialized assistance to develop the original writing?
41. If the document is folded, is this condition consistent with its alleged origin and later repositories?
42. If the document contains creases and folds, allegedly because it was carried about in a pocket or wallet, is the document's condition in respect to soiling consistent with this alleged history? Is the document clean where it should be soiled and vice versa? Do the folds fail to reduce the document small enough to fit the wallet or pocket in which it allegedly was placed?
43. Does the document fit the envelope in which it was allegedly received? Do depressions and impressions correspond? Ink and pencil smudges?
44. If a mailed inclosure, does it bear a latent postmark inconsistent with the visible postmark on the envelope in which it was allegedly inclosed?

45. Does the document bear a watermark consistent with its date?
46. Have you studied both the apparent and latent thought content of the document, for example, an anonymous letter, for evidences of authorship?
47. Have you catalogued the individualities of word choice, colloquialisms, spelling, arrangement, capitalization, and mode of expression for evidences of authorship? Have you delineated the individualities of letter conformation and letter connections?
48. Does the document have a foreign script or language influence even though its alleged author was born and educated in the United States? Or does it have unmistakable "United States" script and language despite the allegation that its author was born and educated in Europe?
49. Are you satisfied that you have scrutinized the document thoroughly from top to bottom, front and back, and accounted for all writing, typewriting, printing, job numbers, marks, holes, discolorations, odors, erasures, folds, creases, seals, bindings, fasteners, indentations, depressions, and what have you, therein and thereon? Have your aggregate inferences supported the representations made by the proponents of the document? Have your aggregate inferences clearly established the document's true origin and subsequent history?
50. Have you consulted a qualified document examiner? Should you now?

SECTION 4
REFERRALS TO THE
INVESTIGATORS

SECTION IV. Making Referrals to the OIG Office of Investigations

Objectives

This section describes when and how to refer indications of possible fraud to the OIG Office of Investigations. The actual investigation of possible fraud is the responsibility of the OIG Office of Investigations. Although auditors should test for conditions conducive to, and indicators of fraud, they need to make timely and accurate referrals when they believe they have identified possible fraud.

A. REASONS FOR PROMPT REFERRAL

1. Investigator may join auditor on-site
2. Witnesses or others involved may: die, move, forget, go on vacation, get sick or change their stories
3. Documents may be: lost, moved, altered, or destroyed
4. Other physical evidence may be: lost, moved, destroyed, or disturbed

B. REFERRAL

1. Auditor's name
2. Name of auditor's supervisor
3. Names and locations of those involved
4. Why the auditor concluded that the matter has sufficient probability to warrant investigation
5. Documentation supporting the conclusion or establishing the potentially fraudulent act
6. Information on and support for the amount of actual or potential loss, if known

UNITED STATES
ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL
401 M STREET, S.W.
WASHINGTON, D.C. 20460

MAY 29 1986

OIG MANUAL

TRANSMITTAL 59

CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS

MATERIAL TRANSMITTED

Chapter 22--Referrals Between Audit
and Investigations

MATERIAL SUPERSEDED

Chapter 22, Issued June 1984

This chapter establishes policies and procedures to promote cooperation and coordination between the Office of Audit and the Office of Investigations.

The chapter has been revised to require only the referral form, not all referral correspondence, to be sent to the AIGs (section 2-5); to describe the OIG Award for Excellence (section 2-6); to clarify the procedures for preparing status reports (section 3); and to include the referral status report (appendix 3).


John C. Martin
Inspector General

Distribution : E

ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL

OIG MANUAL

CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS

TABLE OF CONTENTS

| <u>Paragraph</u> | <u>Page</u> |
|-------------------------------------------------------------------------------|-------------|
| SECTION 1. GENERAL | |
| 1-1. Purpose | 1 |
| 1-2. Background | 1 |
| 1-3. Policy | 1 |
| SECTION 2. INFORMATION EXCHANGES AND REFERRAL REQUESTS | |
| 2-1. Interchange of Information on Planned Audits and Investigations | 2 |
| 2-2. Requests for Audit Assistance on Investigative Matters | 2 |
| 2-3. Referrals for Audit | 4 |
| 2-4. Referrals for Investigations | 4 |
| 2-5. Referral Procedures | 5 |
| 2-6. OIG Award for Excellence | 5 |
| SECTION 3. STATUS REPORTS | |
| 3-1. Status Reports | 5 |
| APPENDIXES | |
| 1--Matters Which May Be Investigated | 7 |
| 2--Referral Form | 13 |
| 3--Referral Status Report | 16 |

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

OIG MANUAL

**CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS**

SECTION 1. GENERAL

- 1-1. PURPOSE. The purpose of this chapter is to establish policies and procedures to promote cooperation and coordination between the Office of Audit and the Office of Investigations.
 - 1-2. BACKGROUND. To maximize efforts to reduce fraud, waste, and abuse, auditors and investigators should work together. In the course of their work, auditors and investigators should be alert to issues that might concern their counterparts. Audits often disclose indicators of violations of laws and regulations which merit the scrutiny of investigators. Investigations often reveal indicators of weaknesses in controls and procedures which deserve the analysis of auditors. Even when joint work is not involved, good communication between offices helps our staff members fight possible fraud, waste, and abuse in EPA programs.
 - 1-3. POLICY. OA and OI should work together to exchange information and resources vital to both offices and to the organization. These offices are responsible for:
 - a. Referring to each other all appropriate matters disclosed by their work or otherwise brought to their attention;
 - b. Providing each other direct audit or investigative assistance on a request basis;
 - c. Providing audit coverage to management weaknesses as requested or disclosed by investigations;
 - d. Providing audit assistance to U.S. Attorneys, the FBI, and other investigative organizations on a request basis as coordinated through OI;
 - e. Participating jointly in projects initiated to uncover fraud, waste, and abuse;
 - f. Avoiding scheduling conflicts that might be detrimental to the work of either office; and
 - g. Maintaining close coordination and communication between offices in both Headquarters and field to facilitate a free flow of information.
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OIG MANUAL

ENVIRONMENTAL PROTECTION AGENCY OFFICE OF INSPECTOR GENERAL

CHAPTER 22--REFERRALS BETWEEN AUDIT AND INVESTIGATIONS

SECTION 2. INFORMATION EXCHANGES AND REFERRAL REQUESTS

2-1. INTERCHANGE OF INFORMATION ON PLANNED AUDITS AND INVESTIGATIONS. The continuing cooperation between OA and OI is essential for:

- a. Consulting on potential referrals for investigation or audit;
- b. Obtaining information about current or recent investigations of audit interest;
- c. Gaining perspective on matters referred to OA by OI, or vice versa;
- d. Exchanging information on matters of mutual interest; and
- e. Planning and working on joint projects.

At Headquarters, there must be a continuing exchange of information between offices. OA should provide OI with a copy of its annual audit plan and quarterly revisions. OI should furnish OA with information on planned investigations which may relate to audits.

At the divisional level, close working relations should exist. Besides exchanging information on planned work, DIGs and staff members should regularly interchange information as matters come up which may be of official interest to one another.

2-2. REQUESTS FOR AUDIT ASSISTANCE ON INVESTIGATIVE MATTERS. OI should request from OA any audit or technical assistance required in carrying out investigations of criminal or civil fraud or other matters.

- a. Contents. The request should set forth the:
 - (1) Nature of the alleged irregularity;
 - (2) Specific matters to be audited;
 - (3) Objectives to be achieved;
 - (4) Specific guidance on how audit results are to be disseminated;
and
 - (5) Timeframes within which the assistance is required.

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

OIG MANUAL

**CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS**

- b. Sources. Requests for audit assistance on investigative matters come from:
- (1) Office of Investigations. OA should make every reasonable effort to provide its expertise where needed to conduct investigations or engage in special joint projects. If the DIGA thinks a request for assistance cannot be accepted because of other priorities, he/she should consult with the AIGA to determine if some adjustment of priorities can be made or if staff from other divisions can be assigned to the referral.
 - (2) Other Investigative Units. Divisional and Headquarters OA officials occasionally receive requests for assistance channeled through OI from U.S. Attorneys, the FBI, and other agencies with investigative or similar responsibilities. If requests are made directly to OA, they should be immediately referred to OI. OI should review such requests and determine the nature and extent of assistance required. If OI finds that audit assistance is needed, the matter will be referred to OA for consideration. OI should coordinate with the requester and OA to ensure that specific understandings are reached with respect to the nature and scope of work, time-frames, staffing requirements, and use which can be made of auditors' work.
- c. Safeguarding Investigatory Process. OA will take necessary steps to ensure that the investigatory process is not compromised. When audit assistance is requested on an investigation where there is an ongoing audit, care must be taken to clearly segregate these two processes. Normally, the DIGA can do this by assigning staff who are not working on the audit to the investigation. In some rare cases, it may be necessary after coordination with OI and the U.S. Attorney to discontinue an audit until conclusion of the investigation.
- OA staff will not disclose in audit reports information which could compromise an investigation or result in an unnecessary invasion of privacy. When OA becomes aware that the auditee, related entity, or persons are under investigation, OA will exclude from the audit report reference to an ongoing or contemplated investigation.
-

OIG MANUAL

ENVIRONMENTAL PROTECTION AGENCY OFFICE OF INSPECTOR GENERAL

CHAPTER 22--REFERRALS BETWEEN AUDIT AND INVESTIGATIONS

- 2-3. REFERRALS FOR AUDIT. OI may refer matters to OA for consideration in its plan of audit assignments. In the course of their work, investigators frequently obtain information that is outside the scope of their investigation and may be of interest to OA. OI should include with the written referral all relevant information on the attached referral form.
- 2-4. REFERRALS FOR INVESTIGATIONS. OA should promptly report indications of criminal violations, civil fraud, conduct violations, and other matters within OI's purview which are detected during audits or otherwise brought to its attention. Determining that a matter should be referred to OI does not result from a mechanical application of rules; rather, such a determination depends on the judgment of the alert auditor based on professional experience and common sense.
- a. Matters Which May Be Investigated. Auditors should be aware that a great variety of matters may be investigated. Appendix 1 of this chapter provides a brief discussion of the most significant matters. In performing audits of EPA programs, grants, and contracts, auditors should be alert to possible indicators of such matters.
 - b. Matters Found During the Course of Audits. Indicators of matters which should be investigated sometimes are found in audits performed by EPA or others. For example, audit reports prepared by independent public accountants, State auditors, or other Federal agencies for OA sometimes disclose indications of fraud, abuse, or other impropriety involving EPA programs and personnel that may necessitate investigation by OI. When these auditors find matters in such reports which may require investigation, they should immediately contact their supervisor and the DIGA. Similarly, when EPA auditors encounter matters which appear to require investigation, they should immediately contact their supervisor.
 - c. Consultation with Investigations. Auditors should continue their normal audit efforts, but should not expand or modify their audit coverage until OA confers with OI. If possible, OA should discuss the matter with OI while the auditor who raised the issue is still at the audit site. The scope of audits should not be altered unless OI indicates that additional information is necessary to determine whether an investigation is appropriate.
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ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL

OIG MANUAL

CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS

- d. Continuation with Audit. Assuming that it would not interfere with an investigation, the auditors should be advised to continue with the remainder of the audit and prepare the draft audit report. After reviewing the workpapers and finalizing the draft report, the DIGA should coordinate the release of the report with OI. OI should review the report to ensure that its release will not interfere with any ongoing investigation. OI should recognize OA's concern about audits being unnecessarily delayed. OI will make every effort to provide OA with guidance in a timely manner. Upon clearance from OI, the report will be finalized and issued in accordance with existing OA procedures.

- 2-5. REFERRAL PROCEDURES. When DIGs think a matter should be referred, they should informally discuss it with their counterparts. If informal discussions confirm that referral is warranted, DIGs should refer the matter in writing. Referrals should contain all available information to assist the recipient in making an informed decision and should be on the attached referral form (see appendix 2).

A copy of the referral form only should be provided to the AIGs in Headquarters by the DIG making the referral. If the responding DIG cannot accept such a referral because of other priorities, the AIG should be consulted to determine if some adjustment can be made of priorities or if staff from other divisions can be assigned to the referral.

- 2-6. OIG AWARD FOR EXCELLENCE. DIGs will have the option each year of nominating an individual or team for an OIG Award for Excellence, which will be presented in recognition of exemplary performance in conducting and referring an audit or investigation. Information relating to the selection process, criteria, and award amounts is detailed in the OIG Manual Chapter 12, Personnel Administration.

SECTION 3. STATUS REPORTS

- 3-1. STATUS REPORTS. To provide necessary feedback between our offices, each DIG who receives a referral should prepare a referral status report (see appendix 3) each quarter listing the status of all open referrals and referrals that were closed that quarter by either completing the requested work or by formally declining the matter. The report should include information such as the division making the referral, a short description of the referral, an identification number, the date referred, the status of the referral, and the estimated closeout date.
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OIG MANUAL

ENVIRONMENTAL PROTECTION AGENCY OFFICE OF INSPECTOR GENERAL

CHAPTER 22--REFERRALS BETWEEN AUDIT AND INVESTIGATIONS

The reports will be sent to the AIGs and each DIG from whom a referral was received. The offices which made the referrals have the responsibility of reviewing these reports and reconciling any differences. These reports will be issued by the 15th day of January, April, July, and October. When there are no changes in the status of referrals from the preceding quarter, a copy of the last report will be sent with a cover letter stating that no changes have occurred.

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

OIG MANUAL

**CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS**

Appendix 1
Page 1 of 6

MATTERS WHICH MAY BE INVESTIGATED

This appendix sets forth the most common matters which should be referred to OI. The elements which constitute various offenses are provided in abridged form for use as general guidance to assist auditors in recognizing possible violations. This is not intended to represent a definitive statement of the elements. Auditors should not attempt to develop information about each element before making referrals. When possible violations are recognized, auditors should seek guidance from their OI counterparts regarding the appropriateness of making a referral.

a. **False Statements** (18 U.S.C. 1001):

- (1) The defendant made or used a false statement (oral/written) or document in relation to a matter within the jurisdiction of a department or agency of the United States;
- (2) The act was done with knowledge that the statement or document was false, fictitious, or fraudulent; and
- (3) The act was done knowingly and willfully.

b. **False Claims** (18 U.S.C. 287):

- (1) The defendant knowingly and willfully made or presented a claim to a Government department or agency;
- (2) The claim was made or presented upon or against a department or agency of the United States;
- (3) The claim was false, fictitious, or fraudulent; and
- (4) The defendant knew the claim was false, fictitious, or fraudulent.

OIG MANUAL

ENVIRONMENTAL PROTECTION AGENCY OFFICE OF INSPECTOR GENERAL

CHAPTER 22--REFERRALS BETWEEN AUDIT AND INVESTIGATIONS

Appendix 1
Page 2 of 6

- c. Conspiracy to Defraud the Government with Respect to Claims (18 U.S.C. 286):
 - (1) An agreement, combination, or conspiracy;
 - (2) Involvement of a department or agency of the U.S. Government;
 - (3) An overt act; and
 - (4) Obtaining or aiding to obtain the payment or allowance of any false, fictitious, or fraudulent claim.
 - d. Theft of Government Property (18 U.S.C. 641). This includes embezzlement, theft, purloining, conversion, unauthorized disposition of Government property, or reception, concealment, or retention of Government property.
 - (1) Intent;
 - (2) Involvement of U.S. property;
 - (3) Knowledge of the ownership; and
 - (4) A loss to the Government.
 - e. Bribery of Public Officials and Witnesses (18 U.S.C. 201):
 - (1) The act of directly or indirectly giving, offering, or promising to a public official or a person who has been selected to be a public official or to a witness a sum of money or thing of value; or
 - (2) The act by said individuals of directly or indirectly asking, demanding, soliciting, securing, receiving, or accepting a sum of money or thing of value;
 - (3) Doing the act willfully and corruptly; and
 - (4) Doing the act with the intent to influence or be influenced in any official act.
-

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

OIG MANUAL

**CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS**

Appendix 1
Page 3 of 6

- f. Misuse of Public Funds (18 U.S.C. 648):
 - (1) Officer or other person charged by act of Congress with safekeeping public money;
 - (2) Loans, uses, converts to own use, deposits, or exchanges;
 - (3) Overt act; and
 - (4) Knowledge and intent.
- g. Concealment, Removal, Obliteration, Mutilation, or Destruction of Official Documents (18 U.S.C. 2071):
 - (1) There must be an actual or attempted concealment, removal, etc.;
 - (2) The act must be willful and unlawful;
 - (3) There must be intent; and
 - (4) The act must involve an official record or document.
- h. Aiding and Abetting (18 U.S.C. 2):
 - (1) Affirmative act or association;
 - (2) Knowledge (criminal intent); and
 - (3) Commission of crime.
- i. Antitrust Violations. Violations of the Sherman Antitrust Act (15 U.S.C. 1):
 - (1) The formulation of a contract, combination, agreement, or conspiracy;
 - (2) The restraint of trade or commerce among the several States.

The following are common bid rigging patterns, violating 15 U.S.C. 1, that agency personnel may be able to recognize:

- (1) Bid Suppression. In "bid suppression" or "bid limiting" schemes, one or several competitors (who would otherwise be expected to bid or who have previously bid) refrain from bidding or withdraw a previously submitted bid so that a competitor's bid will be accepted. In addition, fabricated bid protests may be filed to deny an award to a nonconspirator.
- (2) Complementary Bidding. "Complementary bidding" (also known as "protective" or "shadow" bidding) occurs when competitors submit token bids that are too high to be accepted (or if competitive in price, then on special terms that will not be acceptable). Such bids are not intended to secure the buyer's acceptance, but are merely designed to give the appearance of genuine bidding. This enables another competitor's bid to be accepted when the agency requires a minimum of bidders.
- (3) Bid Rotation. In "bid rotation," all vendors participating in the scheme submit bids, but by agreement take turns being the low bidder. A strict bid rotation defies the law of chance and suggests collusion.

Competitors may also take turns on contracts according to the size of the contract. Many cases of bid rigging have been exposed in which certain vendors or contractors get contracts valued above a certain figure, while others get contracts worth less than that figure.

Subcontracting is another area for attention. If losing bidders or nonbidders frequently receive subcontracts from the successful low bidder, the subcontracts (or supply contracts) may be a reward for submitting a noncompetitive bid or for not bidding at all.

ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL

OIG MANUAL

CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS

Appendix 1
Page 5 of 6

- (4) Market Division. Market division schemes are agreements to refrain from competing in a designated portion of the market. Competing firms may, for example, allocate specific customers or types of customers so that only one firm submits bids on contracts let by a certain class of potential customers. In return, his competitors will not bid on contracts let by the class of customers allocated to him. For example, a vendor of office supplies may agree to bid only on contracts let by certain Federal agencies and refuse to bid on contracts for military bases.

Allocating territories among competitors is also illegal. This is similar to the allocation-of-customer scheme, except that geographic areas are divided instead of customers.

- j. Employee Conduct Violations. The following are common conduct violations. Additional information may be obtained by consulting the U.S.C. or the Code of Federal Regulations (CFR) or by conferring with OI.

- (1) Employment of relatives: 5 U.S.C. 3110(b); 5 CFR 310.103.
- (2) Political activity: 5 U.S.C. 7324-7327, 18 U.S.C. 602, 603, 607 and 608 (Hatch Act); 5 CFR 4.1, 733.121-124; 40 CFR 3.502(b)(3).
- (3) Gifts to supervisors: 5 U.S.C. 7351; 5 CFR 735.202(d).
- (4) Using public office for private gain: 5 CFR 735.201a(a); 40 CFR 3.103(d)(1).
- (5) Accepting gratuities: 5 CFR 735.202(a); 40 CFR 3.400.
- (6) Outside employment noncompatible with Government duties: 5 CFR 735.203(a); 40 CFR 3.500 et seq.
- (7) Receipt of compensation from private sources for Government service: 18 USC 209; 5 CFR 735.203(b).
- (8) Conflict of interest: 18 U.S.C. 208; 5 CFR 735.204(a)(1); 40 CFR 3, subpart A, appendix A.

OIG MANUAL

ENVIRONMENTAL PROTECTION AGENCY OFFICE OF INSPECTOR GENERAL

CHAPTER 22--REFERRALS BETWEEN AUDIT AND INVESTIGATIONS

Appendix 1
Page 6 of 6

- (9) Gambling on duty; 5 CFR 735.208; 40 CFR 3.104(c).
- (10) Disclosing information classified or confidential: 18 U.S.C. 798; 50 U.S.C. 783; 18 U.S.C. 1905; 5 CFR 735.210(f).
- (11) Misuse of Government vehicles: 31 U.S.C. 1344 1249; 5 CFR 735.210(h).
- (12) Misuse of franking privileges: 18 U.S.C. 1719; 5 CFR 735.210(i).
- (13) Giving preferential treatment: 40 CFR 3.103(e)(2).

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

OIG MANUAL

**CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS**

Appendix 2
Page 1 of 3

REFERRAL FORM

| | | | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|----------------------------------------|----------------|
| Referral Form | 1. Date of Report | 2. Audit/Investigation Number | 3. File Number |
| 4. Type of Report. Initial <input type="checkbox"/> Supplemental <input type="checkbox"/> Other <input type="checkbox"/> _____ | | | |
| 5. Area of Concern. Conduct <input type="checkbox"/> Criminal <input type="checkbox"/> Civil <input type="checkbox"/> Administrative <input type="checkbox"/> | | | |
| 6. Referral Involves. EPA Employee <input type="checkbox"/> Contractor <input type="checkbox"/> Grantee <input type="checkbox"/> Other <input type="checkbox"/> _____ | | | |
| 7. Location of Incident | | | |
| 8. Date and Time of Incident/Discovery | | | |
| 9. Source of Information Public <input type="checkbox"/> Contractor <input type="checkbox"/> Grantee <input type="checkbox"/> Audit <input type="checkbox"/> Investigation <input type="checkbox"/> Other <input type="checkbox"/> _____ | | | |
| 10. Expected Concern to EPA Local <input type="checkbox"/> Regional <input type="checkbox"/> National <input type="checkbox"/> Media Interest <input type="checkbox"/> Executive Interest <input type="checkbox"/> GAO/Congressional Interest <input type="checkbox"/> Other <input type="checkbox"/> _____ | | | |
| 11. EPA program Involved: | | 12. Estimated Funds Involved: \$ _____ | |
| 13. Information on Person(s) Involve | | | |
| Name | Grade | Position/Title | Employer |
| | | | |
| | | | |
| 14. Summary of Facts: | | | |

OIG MANUAL

ENVIRONMENTAL PROTECTION AGENCY OFFICE OF INSPECTOR GENERAL

CHAPTER 22--REFERRALS BETWEEN AUDIT INVESTIGATIONS

Appendix 2
Page 2 of 3

| | |
|-----------------------------------------------|------------------|
| 14. Summary of Facts (Cont'd): | |
| | |
| 15. Assistance Requested: | |
| | |
| 16. Date Assistance Needed By: | 17. Attachments: |
| 18. Type Name & Title of Responsible Official | 19. Signature |

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

OIG MANUAL

**CHAPTER 22--REFERRALS BETWEEN AUDIT
AND INVESTIGATIONS**

Appendix 2
Page 3 of 3

INSTRUCTIONS FOR COMPLETING REFERRAL FORM

- ITEM 1 Self-explanatory.
- ITEM 2 OA should use the audit control number or, if work was done by contractor, the audit report number. OI should use the inquiry/case number.
- ITEM 3 Both OI and OA should include in this number their office identifier (OA and OI), division identifier, the fiscal year, and the sequential number of referrals made that fiscal year (e.g., OI-MAD-84-04 for OI, Mid-Atlantic Division, Fiscal 1984, fourth referral).
- ITEMS 4-14 Self explanatory.
- ITEMS 15-16 Both OA and OI should fill in these items when assistance is required. If referral is made for information only, these items need not be completed.
- ITEM 17 Indicate whether there are any attachments and the number of them.
- ITEM 18 Identifies the DIG making the referral.
- ITEM 19 Signature of DIG making the referral.

The original of this report will be sent to the DIG receiving the referral with copies of the referral form only sent to both AIGs.

OIG MANUAL

**ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL**

CHAPTER 22--REFERRALS BETWEEN AUDIT INVESTIGATIONS

Appendix 3

| Referring Division | Short Description of Referral | I.D. No. | Date Referred | Status | Estimate Closeout |
|--------------------|-------------------------------|----------|---------------|--------|-------------------|
| | | | | | |

DIGA

DIGI

Signature

SECTION 5
THE ENVIRONMENT
FOR FRAUD

SECTION V. General Indicators of Fraud and Assessing the Environment
for Fraud

Objectives

This section provides an overview of the general administrative and financial conditions conducive to fraud. It also lists and describes indicators of weak internal controls and how those weaknesses can be abused to commit fraud. In addition, this section identifies behavior, patterns of activity, and documents which could indicate possible fraud, even when strong internal controls appear to be in place. Also presented are lists of common fraudulent acts.

A. OPPORTUNITIES FOR FRAUD WAIT FOR
THE RIGHT ENVIRONMENT

1. ~~Moral~~ climate
2. System of controls

B. MORAL CLIMATE: DANGER SIGNALS

1. High personnel turnover
2. Low employee morale
3. Documentation not available
4. Bank reconciliations delayed
5. Unrealistic job standards
6. Late reports
7. Some employees never vacation

C. INSUFFICIENT INTERNAL CONTROLS

1. Not separating responsibility for:
 - authorization
 - custodianship
 - recordkeeping
2. Not limiting access to assets
3. Not recording transactions
4. Not executing transactions with proper authorization
5. ~~Not~~ implementing prescribed controls
~~due~~ to:
 - lack of personnel
 - unqualified personnel

D. FISCAL/ACCOUNTING CONTROLS: DEFICIENCIES

1. Fiscal control duties not divided
2. Records not posted in a timely manner
3. Payment obligations not recorded or accumulated
4. Funds disbursed without reasonable verification of progress or product
5. Disbursements made without proper authorization
6. Obligations and disbursements not tracked against budget
7. Funds expended for ineligible or improper items
8. Recurrent audit findings
9. Accumulating Federal funds in advance of needs

E. MANAGEMENT CONTROLS: DEFICIENCIES

1. Poorly designed programs
2. Lack of plan or targets for accomplishments
3. Cumbersome, costly or unneeded procedures
4. Duplication of effort
5. Inadequately trained staff
6. Vague work assignments
7. Lack of internal communication
8. Failure to work within approved schedules
9. Failure to act on complaints
10. Inspections not performed or documented
11. Funding projects outside of approved area

F. DANGER SIGNS

1. Lack of cooperation in providing records for audit
2. People living beyond means
3. Refusing to take vacations
4. Unreasonable association with a contractor

G. MORE DANGER SIGNS

1. Poor financial condition
2. Poor timekeeping system
3. Mix in types of contracts
4. History of past fraud
5. One or few individuals who dominate management
6. No internal or external audits

H. WHAT ELSE TO CHECK

1. Personal items paid by company
2. Overpayment and refund
3. Padded payroll
4. Two checks for same invoice
5. No invoices
6. Unusual or large expenditures
7. Loans to third parties
8. Sale of assets

I. COMMON INDICATORS OF FRAUD

1. Two sets of records
2. Alteration of documents
3. Destruction of records
4. Company provides immediate justification for irregularities
5. Employees coached on what to say and withhold

J. MORE COMMON INDICATORS OF FRAUD

1. Failure to correct system deficiencies
2. Inconsistent use of overhead accounts
3. Mistakes always at the Government's cost
4. Use of photo copy of invoices or receipts, not original
5. Second or third party endorsements on company checks

K. SCHEMES AND DETECTION TECHNIQUES

1. Altered timecards/erroneous charges
2. Supervisor posts timecard labor charges
3. False claims/labor fraud
4. Fictitious/nonexistent vendors
5. Increasing vendor invoices
6. Increasing contract price by modifications
7. Theft of materials and supplies
8. Purchasing better quality items than received

L. MORE SCHEMES AND DETECTION
TECHNIQUES

1. Confirmation from bank of balances of bank accounts and loans
2. Confirmation of accounts receivable
3. Theft or illicit sale of fixed assets
4. Checking of collateral
5. Splitting purchases
6. Confirmation of accounts payable
7. Settling of claims
8. Premature withdrawals under a letter of credit

M. MORE SCHEMES AND DETECTION
TECHNIQUES

1. Theft of inventory
2. Inventory cut-offs
3. Questioned costs
4. Claiming unwarranted costs
5. Cash-flow analysis (cash generation)
6. Net worth calculation
7. Lapping
8. Kiting

Exhibit

GENERAL INDICATORS OF FRAUD AND ASSESSING THE ENVIRONMENT FOR FRAUD (Controls)

WARNING SIGNALS OF THE POSSIBLE EXISTENCE OF FRAUD

1. Highly domineering senior management and one or more of the following, or similar, conditions are present:
 - ___ An ineffective board of directors and/or audit committee.
 - ___ Indications of management override of significant internal accounting controls.
 - ___ Compensation or significant stock options tied to reported performance or to a specific transaction over which senior management has actual or implied control.
 - ___ Indications of personal financial difficulties of senior management.
 - ___ Proxy contests involving control of the company or senior management's continuance, compensation, or status.
2. Deterioration of quality of earnings evidenced by:
 - ___ Decline in the volume or quality of sales (for example, increased credit risk or sales at or below cost).
 - ___ Significant changes in business practices.
 - ___ Excessive interest by senior management in the earnings per share effect of accounting alternatives.
3. Business conditions that may create unusual pressures:
 - ___ Inadequate working capital.
 - ___ Little flexibility in debt restrictions such as working capital ratios and limitations on additional borrowings.
 - ___ Rapid expansion of a product or business line markedly in excess of industry averages.
 - ___ A major investment of the company's resources in an industry noted for rapid change, such as a high technology industry.
4. A complex corporate structure where the complexity does not appear to be warranted by the company's operations or size.
5. Widely dispersed business locations accompanied by highly decentralized management with inadequate responsibility reporting system.
6. Understaffing which appears to require certain employees to work unusual hours, to forgo vacations and/or to put in substantial overtime.
7. High turnover rate in key financial positions such as treasurer or controller.

Exhibit

GENERAL INDICATORS OF FRAUD AND ASSESSING THE ENVIRONMENT
FOR FRAUD (Controls)

WARNING SIGNALS OF THE POSSIBLE EXISTENCE OF FRAUD

8. Frequent ~~change~~ of auditors or legal counsel.
9. Known material weaknesses in internal control which could practically be corrected but remain uncorrected, such as:
 - ___ Access to computer equipment or electronic data entry devices is not adequately controlled.
 - ___ Incompatible duties remain combined.
10. Material transactions with related parties exist or there are transactions that may involve conflicts of interest.
11. Premature announcements of operating results or future (positive) expectations.
12. Analytical review procedures disclosing significant fluctuations which cannot be reasonably explained, for example:
 - ___ Material account balances.
 - ___ Financial or operational interrelationships.
 - ___ Physical inventory variances.
 - ___ Inventory turnover rates.
13. Large or unusual transactions, particularly at year-end, with material effect on earnings.
14. Unusually large payments in relation to services provided in the ordinary course of business by lawyers, consultants, agents, and others (including employees).
15. Difficulty in obtaining audit evidence with respect to:
 - ___ Unusual or unexplained entries.
 - ___ Incomplete or missing documentation and/or authorization.
 - ___ Alterations in documentation or accounts.
16. In the performance of an examination of financial statements unforeseen problems are encountered, for instance:
 - ___ Client pressures to complete audit in an unusually short time or under difficult conditions.
 - ___ Sudden delay situations.
 - ___ Evasive or unreasonable responses of management to audit inquiries.

Exhibit

GENERAL INDICATORS OF FRAUD AND ASSESSING THE ENVIRONMENT FOR FRAUD (Controls)

COMMON FORMS/METHODS OF FRAUD AND ABUSE

- Increasing the amounts of supplier's invoices through collusion.
- Issuing credit for false customer claims and returns.
- Lapping collections on customer's accounts.
- Charging personal purchases to the company through the misuse of purchase orders.
- Using carbon copies of previously used original vouchers, or using a properly approved voucher of a prior date by altering the old date.
- Charging customer's accounts by amounts equal to the cash stolen from other accounts.
- Failing to make bank deposits daily, or depositing only part of the money.
- Altering dates on deposit slips to cover stealing.
- Causing erroneous footings of cash receipts and disbursement books.
- Seizing and forging checks payable to the company or suppliers.
- Permitting special prices or privileges to customers, or granting business to favored suppliers for kickbacks.
- Inflating invoices/vouchers/head counts.
- Substituting low quality merchandise while charging prices for high quality merchandise.
- Misrepresenting income and/or concealing assets in welfare type cases.
- Employees claiming overtime that was never performed.
- Employees submitting false information on time and attendance reports to conceal leave taken.

Exhibit

GENERAL INDICATORS OF FRAUD AND ASSESSING THE ENVIRONMENT FOR FRAUD (Controls)

COMMON FORMS/~~METHODS~~ OF FRAUD AND ABUSE (continued)

- Increasing the amounts of supplier's invoices through collusion.
- Issuing credit for false customer claims and returns.
- Lapping collections on customer's accounts.
- Charging personal purchases to the company through the misuse of purchase orders.
- Using carbon copies of previously used original vouchers, or using a properly approved voucher of a prior date by altering the old date.
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- Substituting low quality merchandise while charging prices for high quality merchandise.
- Misrepresenting income and/or concealing assets in welfare type cases.
- Employees claiming overtime that was never performed.
- Employees submitting false information on time and attendance reports to conceal leave taken.

SUMMARY OF SECTION 5.

Remember, a mistake is only a mistake if corrective action is taken. Neglect allowing a pattern to develop is tantamount to intent.

When performing routine audits, the auditor should be alert to indicators of fraud. Obviously, he should look into areas where fraudulent activity is most likely to exist. Some conditions conducive to fraudulent activity are:

- a. Inadequate Internal Control. Any contractor with inadequate internal controls may be a prime candidate for fraudulent activity. For example, a small contractor with a limited staff may have the same person performing incompatible functions. Incompatible functions for accounting control purposes are those that place any person in a position both to perpetrate and conceal errors and irregularities in the normal course of his duties.
- b. Poor Financial Condition. A contractor in poor financial condition will attempt to find ways to cut or minimize his losses or achieve greater profits. In desperation, the contractor may resort to fraudulent activities.
- c. Inadequate Accounting Records. Usually a contractor with inadequate accounting records will also have poor internal controls and will be in a poor financial condition. Inadequate accounting records are an effective means of concealing a fraud.
- d. Poor Timekeeping System. A poor timekeeping system is a significant deficiency, not just from the standpoint of possible labor overcharges but from the fact that overhead and G&A expenses are usually applied to labor costs. Errors in timekeeping and labor distributions should not be dismissed lightly. It may be that what appears to be an error was an intentional entry. Erasures and changes made to time cards should be investigated thoroughly. The employee may have properly recorded his time, but management may have changed the charge to their advantage.
- e. A Mix of Commercial, Fixed Price and Cost Type Contracts. This has been an important indicator of the possibility of contract mischarges. Earlier, we said that before a fraud could be committed, opportunities had to exist. This mix of contract types provides the best "opportunity" available. For example, shifting the cost from a commercial or fixed price contract to a cost type contract or shifting costs from a commercial contract to a fixed price contract in anticipation of negotiating a higher price on a follow-on procurement is an enticing idea with potential for great rewards.

SUMMARY OF SECTION 5 (continued)

- f. A History of Past Frauds. Companies or individuals previously involved in fraudulent activity are more likely to commit a second fraudulent act. These individuals have a tendency to be basically dishonest.
- g. Management Dominated by One or a Few. These individuals exhibit a dominance over the entire organization. The individual does not have to be a member of top management. Their influence is disproportionate to the status of their positions and their principle distinguishing characteristic is the fear they generate. Such individuals usually have the power and the inclination to override internal controls. These individuals are often described as the company "strong men."
- h. Individuals Living Beyond Their Means. Accounting literature and CPA review courses advise auditors to be alert to and aware of individuals living beyond their means. If this situation is encountered, the auditor should consider a review to determine any unusual transactions or occurrences related to functions performed or within the span of control of that employee. For example, is the employee in the purchasing department? If so, he could be the recipient of kick-backs, etc. Perhaps the employee is responsible for material control and has access to high value Government furnished materials.
- i. No Internal or External Audits. The fact that audits are or will be conducted is a deterrent to fraudulent acts. The absence of audits creates a favorable environment for a fraud and is an indication that internal controls and the accounting system may be less than adequate.

SECTION 6

CASE

STUDIES

SECTION VI. Case Studies

Objectives

This section reviews actual referrals made to the OIG Office of Investigations from IPA audits that resulted in significant prosecutive action.

Utica firm fined, 3 execs jailed in EPA fraud case

By JOHN DUNPHY
Free Press Staff Writer

1-84-05

In the first prosecution of its type in the nation, a Utica company has been fined and three of its top officers have been sentenced to prison for submitting more than \$1.3 million in false claims to the Environmental Protection Agency for cleanup costs at a Macomb County toxic dump site.

Environmental Management Corp. (EMANCO) and three of its executives

were sentenced Wednesday by U.S. District Judge Julian Cook for submitting false claims for payments from the EPA's Superfund.

The Superfund was created in 1980 to pay for cleanups at some of the country's worst toxic dump sites and sites of chemical accidents.

U.S. Attorney Roy Hayes said the convictions resulted from the first Superfund prosecutions in the country.

John Perricone, an EPA spokesman, said, "This is the first case where we found a contractor cheating the government on purpose, rather than finding a midnight dumper of wastes."

Perricone said the EMANCO operation was uncovered during a routine EPA audit of the company.

EMANCO PRESIDENT James C. Barnum, 37, of Troy, and Vice-Presidents Daniel Toy, 28, of Mt. Clemens, and Gary Domanski, 43, of Oxford, each were fined \$5,000 and sentenced to serve four months of one-year prison sentences. They were convicted Oct. 2 after pleading guilty.

The company was fined \$10,000.

In 1982, the EPA hired EMANCO as one of four contractors to clean up wastes at Liquid Disposal Inc. in Shelby Township.

Hayes said EMANCO and the executives were charged with conspiracy to defraud the U.S. government for filing false claims to the EPA, using inflated labor costs, labor charges for work that was not performed and inflated costs for a kickback scheme with subcontractors.

According to court documents, EMANCO executives received \$25,041 in kickbacks in 1982 from a company called Waste Acid Services for transporting hazardous wastes from the site.

Another \$11,355 in kickbacks was received by EMANCO in 1983 from Maes Trucking Co. for transporting contaminated soil, according to the court documents. Neither of the firms that paid the kickbacks was charged.

Liquid Disposal, a northern Ma-

The prosecution was the first of its type in the country.

cineration operation, eventually declared bankruptcy after two employees were killed in January 1982 by a hydrogen sulfide leak.

The day after the deaths, the state ordered the incinerator closed, and court action shut down the entire facility in February. In April 1982, the firm went into involuntary bankruptcy.

State officials declared the site one of the worst toxic dump sites in Michigan, making it eligible for Superfund cleanup money.

More than \$3.8 million — most of it federal money — has been spent to package and remove the most threatening poisons at Liquid Disposal and to study possible cleanup measures.

Former EPA Administrator Anne Burford, who was in Detroit on Thursday promoting her new book, said the EPA expected that Superfund, like other federal programs, would be prone to some illegal profiteering.

Burford, who ran the EPA from 1981 until her resignation in 1983, said current congressional proposals to more than quadruple the money available for toxic cleanups — which could give Superfund as much as \$10 billion — would make the program even more susceptible to illegal activities.

"How do you conscientiously manage that? It's a huge infusion of money," Burford said.

Free Press Staff Writer Bob Camp-



UNITED STATES
ENVIRONMENTAL PROTECTION AGENCY
OFFICE OF INSPECTOR GENERAL
NORTHERN DIVISION
4TH FLOOR
10 WEST JACKSON STREET
CHICAGO, ILLINOIS 60604

March 30, 1984

SUBJECT: Audit Report No. P5cH3-05-0226-40836
Audit of Costs Claimed Under Notice to Proceed 68-95-0023
Environmental Management Corp., Utica, MI

FROM: The Inspector General

TO: David J. O'Connor, Head
Procurement Section H
Procurement and Contracts Management Division (PM-214F)

Enclosed are two copies of the subject audit report. Please note that the CPA has taken serious exception to the contractor's accounting system and, in addition to questioning costs, has made recommendations on administrative matters. Also, certain incidents identified in this report have been referred to our Office of Investigations. We understand that EPA recently awarded a similar contract to Environmental Management Corp. for \$2,000,000. We recommend that you assess EPA's vulnerability on that contract in light of the findings disclosed in this audit report.

Your office is designated "action office" for this report. Please respond to the Divisional Inspector General for Audits, Northern Division in accordance with the provisions of EPA Order 2750.2A.

This report is FOR DESIGNATED USE ONLY. The purpose is to provide information for contract negotiations and administration. The information contained in this report is considered to be privileged business information and, as such, is protected from release to the general public by the Freedom of Information Act.

Should you have any questions concerning this report, please contact Michael Rickey at (312) 353-2486.

for Michael A. Rickey
Anthony C. Carroll
For the Inspector General

Enclosures (2)

cc: DIGA Internal Audits Division (A-109)

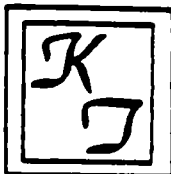
AUDIT OF COSTS CLAIMED BY
ENVIRONMENTAL MANAGEMENT CORP.

UTICA, MICHIGAN

EPA NOTICE TO PROCEED NO. 68-95-0023

FOR THE PERIOD JULY 26, 1982 THROUGH SEPTMEBER 15, 1982

P5CH3-05-0226



Kenneth Toomer
Certified Public Accountant
St. Louis, Missouri 63108

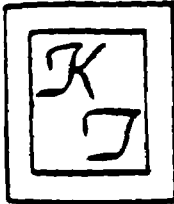
3/30/84

AUDIT OF COSTS CLAIMED BY
ENVIRONMENTAL MANAGEMENT CORP.
UTICA, MICHIGAN
EPA NOTICE TO PROCEED NO. 68-95-0023
FOR THE PERIOD JULY 26, 1982 THROUGH SEPTEMBER 15, 1982
P5CH3-05-0226

KENNETH TOONER
CERTIFIED PUBLIC ACCOUNTANT
ST. LOUIS, MISSOURI

CONTENTS

| | <u>PAGE</u> |
|---------------------------------------------------------------------------------------------------------------------|-------------|
| I. AUDITOR'S REPORT..... | 1-2 |
| II. STATEMENT OF COSTS CLAIMED, ACCEPTED, QUESTIONED, AND SET ASIDE FOR CONTRACT NO. 68-95-0023 (EXHIBIT A)..... | 3 |
| III. LABOR COST (SCHEDULE I)..... | 4-5 |
| IV. NOTES TO SCHEDULE I..... | 6-11 |
| V. EQUIPMENT COST (SCHEDULE II)..... | 12 |
| VI. NOTES TO SCHEDULE II..... | 13-16 |
| VII. MATERIALS COST (SCHEDULE III)..... | 17 |
| VIII. NOTES TO SCHEDULE III..... | 18-21 |
| IX. SUBCONTRACTOR COST (SCHEDULE IV)..... | 22 |
| X. NOTES TO SCHEDULE IV..... | 23-24 |
| XI. DISPOSAL COST (SCHEDULE V)..... | 25 |
| XII. NOTES TO SCHEDULE V..... | 26-27 |
| XIII. OVERHEAD DETERMINATION (SCHEDULE VI)..... | 46 |
| XIII. NOTES TO SCHEDULE VI..... | 47-48 |
| XIV. GENERAL ADMINISTRATIVE MATTERS (EXHIBIT B)..... | 49-50 |



Kenneth Toomer

Certified Public Accountant

(314) 367-9100

629 N Euclid, Suite 210

St. Louis, Missouri 63108

Divisional Inspector General for
Audits Northern Division
Office of the Inspector General
U.S. Environmental Protection Agency
10 West Jackson, Fourth Floor
Chicago, Illinois 60604

I have examined the costs claimed by the Environmental Management Corporation (contractor), under EPA Contract Notice to Proceed No. 68-95-0023. This contract covered site security, safety and loss abatement at the Liquid Disposal, Inc. site in Utica, Michigan.

Except as set forth in the following paragraph, my examination was made in accordance with the "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions", revised in 1981 by the Comptroller General, and Section II-D of the "Audit Guide--Emergency Response Actions". Accordingly, my audit included such tests of the accounting records and such other auditing procedures as I considered necessary in the circumstances.

The purpose of my examination was to perform a complete cost-incurred audit and provide a reconciliation of all elements of cost to the contracting officer to aid in the definitization of this Notice to Proceed on a fixed price basis. Accordingly, my audit was limited in scope to include only the following:

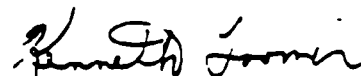
1. Labor and equipment hours and rates.
2. Materials purchased and expended.
3. Types and amounts of wastes transported and disposed of.
4. Subcontract costs.
5. Any other costs charged to the Government.
6. Determine if the rates being charged qualify as established catalog or market prices within the definition provided in 41 CFR 1-3.807-1(2).
7. I relied upon EPA Form 1900-55, signed by the On Scene Coordinator, to verify that quantities of materials and labor billed were actually delivered at the job site and necessary to the successful completion of the project.

Since the EPA limited the scope of the audit, as noted in the preceding paragraph, my opinion is limited to those objectives identified as includable. In my opinion Exhibit A, Schedules I through VI and the accompanying notes to the Schedules present fairly the information contained therein in accordance with the financial provisions of the contract.

Divisional Inspector General for
Audits Northern Division
Page Two

Based on information obtained during my examination, I have also prepared general administrative comments as shown in Exhibit B.

This report is intended for use in connection with the contract to which it refers and should not be used for any other purpose.


KENNETH TOOMER
CERTIFIED PUBLIC ACCOUNTANT

St. Louis, Missouri
January 20, 1984

VI-4-2

EXHIBIT A

ENVIRONMENTAL MANAGEMENT CORPORATION
UTICA, MICHIGAN
EPA CONTRACT NO. 68-95-0023
STATEMENT OF COSTS CLAIMED, ACCEPTED, QUESTIONED AND SET-ASIDE
FOR THE PERIOD JULY 26, 1982 THROUGH SEPTEMBER 15, 1982

| | <u>Total Costs</u> | | | | <u>Reference</u> |
|--------------------|------------------------------|------------------------------|-----------------------------|-----------------------------|------------------|
| | <u>Claimed</u> | <u>Accepted</u> | <u>Questioned</u> | <u>Set Aside</u> | |
| Labor cost | \$ 26,454.75 | \$ --- | \$26,454.75 | \$ --- | Schedule I |
| Equipment cost | 19,046.27 | 395.00 | 4,773.39 | 13,877.88 | Schedule II |
| Materials cost | 5,956.01 | 1,423.99 | 4,532.02 | --- | Schedule III. |
| Subcontractor cost | 18,683.04 | 13,773.54 | 4,909.50 | --- | Schedule IV |
| Disposal cost | <u>174,804.00</u> | <u>119,246.10</u> | <u>55,557.90</u> | <u>---</u> | Schedule V |
| Total | <u>\$244,944.07</u> ***** | <u>\$134,838.63</u> ***** | <u>\$96,227.56</u> ***** | <u>\$13,877.88</u> ***** | |

* Employee paid less than
amount billed the Government

ENVIRONMENTAL MANAGEMENT CORPORATION
UTICA, MICHIGAN
EPA CONTRACT NO. 68-95-0023
LIQUID DISPOSAL, INC. SITE - UTICA, MICHIGAN
LABOR COST

SCHEDULE

4-4-77

| | | Labor Hours | | Labor Rates | | Labor Costs | | Total Labor Costs | | | Ref |
|---------------|----------------|-------------|--------------------|-------------|---------|------------------|-------------|-------------------|-----------|-------------|-----|
| | | Type | (Note 1) Billed | Paid | Billed | (Note 2) Paid | Billed | Accepted | Set Aside | Questioned | |
| James Barnum | Superintendent | Straight | 121.00 | \$ * .00 | \$25.00 | \$ * .00 | \$ 3,025.00 | \$ --- | \$ --- | \$ 3,025.00 | No |
| | | Overtime | 15.50 | --- | 37.50 | --- | 581.25 | --- | --- | 581.25 | No |
| | | Travel | 19.00 | --- | 25.00 | --- | 475.00 | --- | --- | 475.00 | No |
| Dan Toy | Foreman | Straight | 160.00 | * .00 | 21.00 | * .00 | 3,360.00 | --- | --- | 3,360.00 | No |
| | | Overtime | 22.00 | --- | 31.50 | --- | 693.00 | --- | --- | 693.00 | No |
| | | Travel | 24.00 | --- | 21.00 | --- | 504.00 | --- | --- | 504.00 | No |
| Gary Domanski | Technician | Straight | 107.00 | * .00 | 18.00 | * .00 | 1,926.00 | --- | --- | 1,926.00 | No |
| | | Overtime | 16.50 | --- | 27.00 | --- | 445.50 | --- | --- | 445.50 | No |
| | | Travel | 15.00 | --- | 18.00 | --- | 270.00 | --- | --- | 270.00 | No |
| Darrell | Operator | Straight | 94.00 | * .00 | 18.00 | * .00 | 1,692.00 | --- | --- | 1,692.00 | No |
| | | Overtime | 10.00 | --- | 27.00 | --- | 270.00 | --- | --- | 270.00 | No |
| | | Travel | 16.00 | --- | 18.00 | --- | 288.00 | --- | --- | 288.00 | No |
| Wymen | Operator | Straight | 40.75 | * 0 | 18.00 | * . | 733.50 | --- | --- | 733.50 | No |
| | | Overtime | 6.00 | * 5 | 27.00 | * . | 162.00 | --- | --- | 162.00 | No |
| | | Travel | 8.00 | --- | 18.00 | --- | 144.00 | --- | --- | 144.00 | No |
| Wymen | Laborer | Straight | 4.00 | * .00 | 15.00 | * .00 | 60.00 | --- | --- | 60.00 | No |
| | | Travel | 1.00 | --- | 15.00 | --- | 15.00 | --- | --- | 15.00 | No |
| Robert | Operator | Straight | 191.50 | * 0 | 18.00 | * . | 3,447.00 | --- | --- | 3,447.00 | No |
| | | Overtime | 26.00 | * . | 27.00 | * . | 702.00 | --- | --- | 702.00 | No |
| | | Travel | 25.00 | --- | 18.00 | --- | 450.00 | --- | --- | 450.00 | No |
| Robert | Foreman | Straight | 4.00 | * 0 | 21.00 | * .00 | 84.00 | --- | --- | 84.00 | No |
| | | Travel | 1.00 | --- | 21.00 | --- | 21.00 | --- | --- | 21.00 | No |
| Ed | Technician | Straight | 24.00 | --- | 18.00 | --- | 432.00 | --- | --- | 432.00 | No |
| | | Overtime | 4.50 | --- | 27.00 | --- | 121.50 | --- | --- | 121.50 | No |
| | | Travel | 5.00 | --- | 18.00 | --- | 90.00 | --- | --- | 90.00 | No |
| Doug | Laborer | Straight | 69.50 | * . | 15.00 | * . | 1,042.50 | --- | --- | 1,042.50 | No |
| | | Overtime | 11.50 | * . | 22.50 | * . | 258.75 | --- | --- | 258.75 | No |
| | | Travel | 12.00 | --- | 15.00 | --- | 180.00 | --- | --- | 180.00 | No |
| Dan | Laborer | Straight | 16.00 | --- | 15.00 | --- | 240.00 | --- | --- | 240.00 | No |
| | | Overtime | 3.50 | --- | 22.50 | --- | 78.75 | --- | --- | 78.75 | No |
| | | Travel | 2.00 | --- | 15.00 | --- | 30.00 | --- | --- | 30.00 | No |

ENVIRONMENTAL MANAGEMENT CORPORATION
UTICA, MICHIGAN
EPA CONTRACT NO. 68-95-0023
LIQUID DISPOSAL, INC. SITE - UTICA, MICHIGAN
LABOR COST

| | | <u>Labor Hours</u> | | <u>Labor Rates</u> | | <u>Labor Costs</u> | | <u>Total Labor Costs</u> | | | <u>Reference</u> |
|--------|----------|--------------------|----------------------------|--------------------|---------------|--------------------------|---------------|--------------------------|------------------|-------------------|------------------|
| | | <u>Type</u> | <u>(Note 1) Billed</u> | <u>Paid</u> | <u>Billed</u> | <u>(Note 2) Paid</u> | <u>Billed</u> | <u>Accepted</u> | <u>Set Aside</u> | <u>Questioned</u> | |
| Larry | Laborer | Straight | 24.00 | \$ * | 15.00 | \$ *.00 | \$ 360.00 | \$ --- | \$ --- | \$ 360.00 | Note 3 |
| | | Overtime | 6.00 | --- | 22.50 | --- | 135.00 | --- | --- | 135.00 | Note 4 |
| | | Travel | 3.00 | --- | 15.00 | --- | 45.00 | --- | --- | 45.00 | Note 5 |
| Edward | Operator | Straight | 8.00 | --- | 18.00 | --- | 144.00 | --- | --- | 144.00 | Note 6 |
| | | Overtime | 2.50 | --- | 27.00 | --- | 67.50 | --- | --- | 67.50 | Note 6 |
| | | Travel | 1.00 | --- | 18.00 | --- | 18.00 | --- | --- | 18.00 | Note 5 |
| Donna | Clerk | Straight | 236.00 | * | 12.00 | * | 3,216.00 | --- | --- | 3,216.00 | Note 3 |
| | | Overtime | 33.00 | * | 18.50 | * | 647.50 | --- | --- | 647.50 | Note 4 |
| Totals | | | | | | | \$26,454.75 | \$ --- | \$ --- | \$26,454.75 | |
| | | | | | | | ----- | ----- | ----- | ----- | |

VI-4-5-

ENVIRONMENTAL MANAGEMENT CORPORATION
UTICA, MICHIGAN
EPA CONTRACT NO. 68-95-0023
LIQUID DISPOSAL, INC. - UTICA, MICHIGAN

NOTES TO SCHEDULE I

NOTE 1: GENERAL

The hours billed agree 100 percent to the hours recorded on EPA Form 1900-55, and approved by the EPA On-Scene Coordinator (OSC). Based upon his certification of the quantities and his approval of the contractor's final invoice with related costs, I would normally set aside the straight time hourly costs in excess of the rates actually paid pending EPA rate negotiations. However, because of following problems and others pointed out in other sections of this report, I am compelled to question essentially all costs. Some costs are certainly allowable because the task was completed; but I am unable, with a sufficient degree of certainty, to attest to either the reasonableness or absolute accuracy of the services or materials rendered.

My examination revealed what I believe to be serious billing problems on this contract. I have noted several instances where various employees have billed labor time for on site work and they have also been billed as part of a disposal rate for driving waste hauling vehicles. I have also noted two instances where employees have supposedly been driving waste hauling vehicles on this contract and at the same time their daily project report and "other client" invoices indicate they were elsewhere.

The contractor has been billing a standard rate per gallon (which includes labor) for hauling waste to each of two disposal sites. The standard labor hours included in calculating a round trip from the waste site to the Chem-Met disposal facility is 11 1/2 hours and to the Waste Acid facility is 9 hours. I have discovered instances of employees charging 10 hours of on-site labor and also charging for driving one or more loads to the disposal facility--this is a physical impossibility.

In one instance an employee charged 9 hours as foreman while the disposal manifests indicate he drove 3 separate loads to the waste facilities. The 9 hours as foreman plus the 29 1/2 standard hours charged for disposal driving indicates this person must have worked a 38 1/2 hour day or else there was a defect in the pricing determination.

The problem of excessive cost for disposal will be discussed in more detail in a later section of this report and is included here only to reinforce my opinion that a serious problem exists with this contract and that I do not have the utmost confidence in either the contractor's records or the certifications by the OSC.

NOTES TO SCHEDULE I (continued)

As a result of this situation, I could not verify all hours worked or billed. I can only attest that the labor hours on the 1900-55 forms agree with the final invoice and that the OSC signed both.

NOTE 2: LABOR PAID

This amount represents application of the hourly rate paid to the hours billed.

NOTE 3: HOURLY RATES

\$18,946.00

This is a relatively new company with little established cost history, and the contractor was unable to provide documentation regarding the development of the labor rates charged. I was informed by the contractor that the hourly rates were determined in an "informal" manner, based upon the owners' prior experiences as employees of other companies providing similar services.

The contractor's labor accounting system was totally inadequate to record hours worked on this contract. No time cards were available for the following employees:

James Barnum
Dan Toy
Gary Domanski
Darrell
Ed
Dan
Ed
Lawrence -

The contractor claimed that independent time records were not necessary since all hours worked were documented on a daily basis by a Personnel Entry and Exit Log maintained at the job site. I was unable to review the log because a copy was not retained by the contractor at his place of business. Furthermore, the original log, according to the contractor, had been "lost by the EPA". Also, there were no payroll records for Ed , Dan and Edward .

Article VI - Consideration and Payment of this contract requires:

- A. "The number of hours for which the Government will reimburse the Contractor shall include only the time of employees whose services are applied directly to the work specified herein. The Contractor shall maintain time and labor distribution records for all such employees to substantiate the number hours for which the Contractor claims reimbursement. These records shall be maintained for each employee providing services hereunder and shall document the time worked during the period of performance of the work specified above."

NOTES TO SCHEDULE I (continued)

The contractor's rates are stated on a price list. However, I do not feel at this point in time the contractor's price list is acceptable as a bona fide catalog price list. There are not substantial sales to commercial customers who meet the test of the general public. Furthermore, the condition of the contractor's accounting records would prohibit me from approving their rates.

I noted, however, that labor rates charged to EPA agreed without exception to rates per the contractor's "Hazardous Material, Spill Clean-Up Services Price List" (Appendix A) included in his source list application.

In order to assist the contracting officer to definitize the contract, I have provided a schedule (See Attachment 1 to Schedule I) indicating the labor rates charged by the contractor for the same service to other customers. My review indicated that rates charged to EPA were either comparable or more favorable than those charged to other clients except for overtime charges for laborers.

The variation between the rates paid as opposed to the rates billed would ostensibly cover allocable overhead and profit. However the increases range from 275 percent to 500 percent. I believe these rates to be excessive and refer the negotiator to the overhead analysis (Schedule VI) for assistance in negotiating a reasonable overhead rate and profit.

As previously stated, I normally set aside all hourly labor costs pending a definitized hourly labor rate. In this case, however, I am compelled to question all costs due to poor, non-existent or conflicting documentation.

NOTE 4: OVERTIME PREMIUM

\$3,895.00

It is EPA's policy to allow overtime premium when the overtime hours billed are hours worked in excess of eight hours at one site and the overtime premium has been paid to the employee.

Based on my review of the form 1900-55's, it appeared that overtime costs billed to EPA were for bona fide overtime hours. I could not, however, verify that overtime was paid to all employees.

There were no time records for Larry and Darrel . The payroll register indicated that overtime had been paid to these employees, but due to the lack of time records, I could not confirm that overtime paid was directly related to this contract. I have, therefore, questioned overtime costs associated with these employees.

The owners, James Barnum, Dan Toy, and Gary Domanski, are salaried employees. These employees were not paid any overtime. I

NOTES TO SCHEDULE I (continued)

was advised by the contractor that salaried employees were at least partially, if not wholly, compensated in time off for overtime hours worked. I could not verify his statement because there is no system of recording and controlling compensatory time earned and taken. Accordingly, the overtime costs are questioned.

Because of the poor, non-existent or conflicting records, I am compelled to question all overtime costs. Several overtime amounts are questioned under other "notes".

NOTE 5: TRAVEL COSTS

\$2,530.00

The contractor charged one hour per day per employee to cover travel time back and forth to the site. This is not a usual practice of EPA, nor does the contractor charge travel time to all his clients. Furthermore, I could not verify that all travel costs had been paid to the contractor's employees due to the lack of timekeeping and payroll records. Accordingly, all travel costs billed to the EPA are questioned.

NOTE 6: UNSUPPORTED COSTS

\$1,083.75

The contractor did not have payroll records for three employees. I could not, therefore, confirm that these employees had been paid. Two of these employees, Dan and Edward, in the words of the contractor were "paid through Bob's check". The contractor admitted this method of payment was improper but stated that these employees were temporary help and he "did not want to go through the work of putting them on the payroll".

Ed was paid through the company's operating account. Evidence exists to support the fact that this employee was paid an amount of money; however, from the contractor's records, I could not determine if the money he was paid was compensation for time worked on this contract.

I have questioned all labor costs associated with these employees. My calculation of questioned costs is as follows:

| <u>Employee</u> | <u>Costs Questioned</u> |
|-----------------|-------------------------|
| Ed | |
| Straight time | \$ 432.00 |
| Overtime | 121.50 |
| Dan | |
| Straight time | 240.00 |
| Overtime | 78.75 |

NOTES TO SCHEDULE I (continued)

| <u>Employee</u> | <u>Costs Questioned</u> |
|------------------|-------------------------|
| Edward | |
| Straight time | 144.00 |
| Overtime | 67.50 |
| Total Questioned | <u>\$1,083.75</u> |
| | ***** |

NOTE 7: MATH ERROR

\$421.00*

Labor costs for Donna
detailed below:

were inaccurately extended as

| | <u>Hours</u> | x | <u>Rate</u> | = | <u>Labor Cost</u> | <u>Cost Claimed</u> | <u>Cost Questioned</u> |
|------------------|--------------|---|-------------|---|-----------------------|-------------------------|----------------------------|
| Straight Time | 236 | x | \$12.00/hr | = | \$2,832.00 | \$3,216.00 | \$384.00 |
| Overtime | 33 | x | 18.50/hr | = | 610.50 | 647.50 | 37.00 |
| | | | | | <u>\$3,442.50</u> | <u>\$3,863.50</u> | <u>\$421.00</u> |
| | | | | | ***** | ***** | ***** |

*This amount included in total costs questioned under Note 3.

ATTACHMENT 1 TO SCHEDULE 1

ENVIRONMENTAL MANAGEMENT CORPORATIONUTICA, MICHIGANEPA CONTRACT NO. 68-95-0023LABOR RATE COMPARISONHOURLY LABOR RATES

| | Hourly Rates Charged To | | | | |
|----------------|-------------------------|--------------------|-----------------------|------------------------|-----------------------|
| | <u>EPA</u> | <u>Coast Guard</u> | <u>Ford Motor Co.</u> | <u>Lamb Technician</u> | <u>General Motors</u> |
| Superintendent | | | | | |
| Straight time | \$25.00 | \$25.00 | \$ | \$ | \$ |
| Overtime | 37.50 | 37.50 | | | |
| Travel time | 25.00 | | | | |
| Foreman | | | | | |
| Straight time | 21.00 | 21.00 | 21.00 | 21.00 | 21.00 |
| Overtime | 31.50 | 31.50 | 31.50 | | 31.50 |
| Travel time | 21.00 | | | | |
| Technician | | | | | |
| Straight time | 18.00 | 18.00 | 18.00 | | |
| Overtime | 27.00 | 27.00 | 27.00 | | |
| Travel time | 18.00 | | | | |
| Operator | | | | | |
| Straight time | 18.00 | 18.00 | 18.00 | 18.00 | |
| Overtime | 27.00 | 27.00 | 27.00 | | |
| Travel time | 18.00 | | | | |
| Laborer | | | | | |
| Straight time | 15.00 | 15.00 | 15.00 | 15.00 | 15.00 |
| Overtime | 22.50 | | 21.00/22.00* | | |
| Travel time | 15.00 | | | | |
| Clerk | | | | | |
| Straight time | 12.00 | | | | |
| Overtime | 18.50 | | | | |

*Overtime for this category was billed at \$21.00/hour on an invoice dated August 16, 1982 and \$22.00/hour on an invoice dated September 30, 1982.

ENVIRONMENTAL MANAGEMENT CORPORATION
UTICA, MICHIGAN
EPA CONTRACT NO. 68-95-0023
LIQUID DISPOSAL, INC. SITE - UTICA, MICHIGAN
EQUIPMENT COST

| <u>Type of Equipment</u> | <u>No. of Days/Hrs. Billed</u> | <u>Cost per Day/Hrs.</u> | <u>Costs</u> | | | | <u>References</u> |
|----------------------------------------|----------------------------------------|------------------------------|----------------|-----------------|-------------------|------------------|-------------------|
| | | | <u>Claimed</u> | <u>Accepted</u> | <u>Questioned</u> | <u>Set Aside</u> | |
| 3,000 gal. vacuum truck & driver | 129.00 hrs. | \$58.00/hr. | \$ 7,482.00 | \$ --- | \$ 957.00 | \$ 6,525.00 | Note 2 |
| 6,600 gal. vacuum truck no. 1 & driver | 19.25 hrs. | 80.25/hr. | 1,544.81 | --- | 662.06 | 882.75 | Note 3 |
| 6,600 gal. vacuum truck no. 2 & driver | 4.55 hrs. | 80.25/hr. | 365.14 | --- | 365.14 | --- | Note 3 |
| 8,000 gal. vacuum truck & driver | 27.50 hrs. | 58.00/hr. | 1,595.00 | --- | 1,038.40 | 556.60 | Note 4 |
| Operations vehicle | 133.00 hrs. | 9.66/hr. | 1,284.78 | 225.00 | 1,059.78 | --- | Note 5 |
| Staff autos no. 1 & 2 | 164.50 hrs. | 5.25/hr. | 861.01 | 170.00 | 691.01 | --- | Note 6 |
| Fiberglass boat | 13 days | 12.00/day | 156.00 | --- | --- | 156.00 | |
| Scott air pack | 26 days | 50.00/day | 1,300.00 | --- | --- | 1,300.00 | Note 7 |
| Bio back | 47 days | 50.00/day | 2,350.00 | --- | --- | 2,350.00 | Note 7 |
| Eye wash | 26 days | 5.00/day | 130.00 | --- | --- | 130.00 | |
| 100 ft boom | 1 day | 60.00/day | 60.00 | --- | --- | 60.00 | |
| 50 ft boom | 12 days | 90.00/day | 1,080.00 | --- | --- | 1,080.00 | |
| Stake truck & driver | 16.50 hrs. | 50.60/hr. | 834.90 | --- | --- | 834.90 | |
| Contractor billing error | | | 2.63 | --- | --- | 2.63 | |
| Total | | | \$19,046.27 | \$395.00 | \$4,773.39 | \$13,877.88 | |
| | | | ----- | ----- | ----- | ----- | |

III-4
-12-

ENVIRONMENTAL MANAGEMENT CORPORATION
UTICA, MICHIGAN
EPA CONTRACT NO. 68-95-0023

NOTES TO SCHEDULE II

NOTE 1: GENERAL

Quantities billed agree to the quantities recorded on EPA Form 1900-55. The contractor did not retain any equipment logs or other data by which I could confirm the data on the 1900-55 forms on an independent basis. I noted several instances of equipment being charged for and acknowledged on the 1900-55 forms such as tankers being used for hauling hazardous materials, but there is no record (manifest) of these vehicles ever reaching the disposal site or making a materials dump. This will be discussed in a later note.

I was informed by the contractor that rates for all equipment were established in an informal manner as equipment became necessary at the job site. The contractor has no calculations to support his rates. Therefore, I have no basis for measuring the reasonableness of these costs and accordingly, they have been set aside except where costs were questioned for specific reasons.

The contractor's rates are based on a price list submitted to EPA. It is my opinion that the price list does not qualify as a bona fide catalog price list.

In order to assist the contracting officer to definitize this contract, I have provided information regarding equipment rates charged to other customers for similar services. See Attachment 1 to Schedule II.

From the information provided in Attachment 1 to Schedule II, I noted that other customers had been charged a more favorable rate than the EPA for an operations vehicle and an 8,000 gallon tanker. I have questioned the difference in rates for these items in the respective Notes.

NOTE 2: 3,000 GALLON TANKER AND DRIVER \$957.00

Contractor billed for 16 1/2 hours of usage on this vehicle for July 26 and 28. I analyzed the manifests from the disposal site and no materials were disposed of on these dates.

NOTE 3: 6,600 GALLON VACUUM TANKER AND DRIVER \$1,027.20

Contractor billed for 12 3/4 hours of usage on two vehicles for July 26 and 28. I analyzed the manifests from the disposal site and no materials were disposed of on these dates.

NOTES TO SCHEDULE II (continued)

NOTE 4: 8,000 GALLON TANKER AND DRIVER

\$1,038.40

Contractor billed for 16 1/2 hours of usage on this vehicle for July 26 and 28. I analyzed the manifests from the disposal site and no materials were disposed of on these dates.

The contractor also charged an incorrect hourly rate of \$58.00. His published rate is \$50.60 resulting in an overcharge of \$81.40 for those hours not already questioned in total.

NOTE 5: OPERATIONS VEHICLE

\$1,059.78

The "operations" vehicle was in fact Mr. Domanski's pick up truck which he uses for commuting and which he said he also drove to the waste site and "ran errands in." I believe the rate he billed for this vehicle is excessive not only because he charged the EPA more than either the Coast Guard or Ford Motor Co. (Attachment 1 to Schedule II), but also because a mileage allowance would be more reflective of the value given and received.

| | |
|----------------------------|-------------|
| Hourly rate charged to EPA | \$ 9.66/hr. |
| Less: Hourly rate charged | |
| to other customers | 5.25/hr. |
| Difference in rate | \$ 4.41/hr. |
| Hours charged to EPA | x 133 |
| Costs Questioned | \$586.53 |
| | ***** |

The operations vehicle was billed to the EPA for 15 days. I estimate that 75 miles a day should be a reasonable allowance for a round trip from the office to the site taking into consideration that some errands needed to be run. My calculation for this part of the cost questioned is as follows:

| |
|------------------------------|
| \$ 75 mile daily allowance |
| x 15 days |
| 1,125 miles |
| x .20 per mile reimbursement |
| \$ 225. allowable cost |
| ***** |

| | |
|--------------------|------------|
| Total cost claimed | \$1,284.78 |
| Less rate variance | 586.53 |
| | \$ 698.25 |

| | |
|------------------------------|-----------|
| Less: | |
| Acceptable mileage allowance | 225.00 |
| Unreasonable cost questioned | \$ 473.25 |
| | ***** |

NOTES TO SCHEDULE II (continued)

| | |
|---------------------|-------------------|
| Cost Questioned: | |
| Rate variance | \$ 586.53 |
| Unreasonable rental | 473.25 |
| Cost Questioned | <u>\$1,059.78</u> |
| | ***** |

NOTE 6: STAFF AUTOMOBILES

\$691.01

This represents a charge for the personal automobiles of two of the owners--neither car was owned by the contractor at the time of this contract. The automobiles were purchased by the corporation from the employee owners after this contract was completed.

In my opinion, the maximum allowable expense for use of these automobiles should be a simple mileage allowance to travel from the office to the site and return. Fifty miles is more than adequate for a round trip. The cost questioned is calculated as follows:

| | |
|-----|-----------------------------------------|
| | 17 days usage charged |
| x | 50 miles |
| | <u>850 miles</u> |
| x\$ | .20 per mile |
| | <u>\$170.00 allowable</u> |
| | 691.01 unreasonable rental (questioned) |
| | <u>\$861.01 Total Claimed</u> |
| | ***** |

NOTE 7: SAFETY EQUIPMENT

I did not question any cost in this category; however, I want to point out that on a daily basis on the 1900-55 forms the contractor billed \$100 a day for each of 2 "Bio-Packs" and 1 "Scott Air Pack". By the end of the contract he had decided that this was excessive and adjusted his final invoice to reflect only 1/2 the amount he had charged on the daily 1900-55 forms.

The original billing was \$7,150.00 and the final adjusted invoice was for \$3,650.00. According to the information available to us this equipment cost \$2,032.00.

I think this is a further indication of the relative lack of administrative and financial control during the performance of this contract.

ATTACHMENT 1 TO SCHEDULE II

ENVIRONMENTAL MANAGEMENT CORP.
 UTICA, MICHIGAN
 EPA CONTRACT NO. 68-95-0023
EQUIPMENT COST COMPARISON

| <u>Equipment</u> | <u>Rates Charged to</u> | | | | |
|------------------------------|-------------------------|--------------------|-----------------------|------------------------|-----------------------|
| | <u>EPA</u> | <u>Coast Guard</u> | <u>Ford Motor Co.</u> | <u>Lamb Technician</u> | <u>General Motors</u> |
| Scott Air Pack | \$50.00/day | | \$120.00/day | | |
| Bio Pack | 50.00/day | | | | |
| Portable Eye Wash | 5.00/day | | | | |
| 14' Boat | 12.00/day | | | | |
| Operations Vehicle | 9.66/hr. | \$ 5.25/hr. | 5.25/hr. | \$ 9.66/hr. | |
| Stake Truck/driver | 50.60/hr. | | | | |
| 3,000 gal. vac truck/driver | 58.00/hr. | 58.00/hr. | 58.00/hr. | 58.00/hr. | \$58.00/hr. |
| 6,600 gal. vac truck/driver | 80.25/hr. | 80.25/hr. | 80.25/hr. | | 80.25/hr. |
| 8,000 gal. tank truck/driver | 58.00/hr. | | 50.60/hr. | | 50.60/hr. |
| Staff Auto | 5.25/hr. | | | | |
| 100 ft. boom | 60.00/day | | 60.00/day | | |
| 150 ft. boom | 90.00/day | | | | |

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

UNITED STATES OF AMERICA,

Plaintiff,

vs.

CRIMINAL NO. 85-80596

HONORABLE JULIAN COOK

JAMES CHARLES BARNUM,
DANIEL LEE TOY,
GARY HENRY DOMANSKI,
ENMANCO CORPORATION, a/k/a
Environmental Management
Corporation,

Defendants.

GOVERNMENT'S SENTENCING MEMORANDUM

NOW COMES the United States of America, by and through its attorneys, Roy C. Hayes, United States Attorney, and James L. McCarthy, Assistant United States Attorney, both for the Eastern District of Michigan, Southern Division and submits this memorandum pursuant to Rule 32(a)(1) of the Federal Rules of Criminal Procedure.

The purpose of this memorandum is to highlight pertinent information concerning the defendants' conduct in order to provide information appropriate to the imposition of sentence. Because this case has been resolved by means of pleas of guilty rather than by trial, copies of reports, analyses and other documents have been attached to this memorandum for the purpose of giving the sentencing court a complete version of the government's version of the facts of this case. The attached records also allow the court to review the formula

Nov 8 4 11 PM '85
U.S. DISTRICT COURT
EASTERN DISTRICT OF MICH.

FILED

used by the government to determine the estimated loss of approximately \$146,988.45.

In an attempt to make punishment commensurate with the offense, the trial judge may consider a broad range of information concerning the defendant. 18 U.S.C. §3537 provides:

No limitations shall be placed on the information concerning the background, character and conduct of the person convicted of an offense which a court of the United States may receive and consider for the purpose of imposing an appropriate sentence.

In determining the sentence, the court, within its discretion, may properly assess the possibility of rehabilitation, the societal interest in retribution, and the potential, individual and general deterrent effect of its sentence. The history and philosophy of sentencing is that, "the punishment should fit the offender and not merely the crime." Williams v. New York, 337 U.S. 241, 247 (1949).

Government's Version Of Facts

In May 1981 defendants Barnum, Domanski, and Toy originally approached James Bentley, owner of Bentley Oil, Taylor, Michigan to form a new company to secure EPA government contracts to clean up hazardous waste sites. The company was named Environmental Management Corporation with the partnership divided between Bentley (30%), Domanski (30%), Barnum (30%), and Toy (10%). Since neither Barnum, Toy, nor Domanski had sufficient money or equipment, Bentley put approximately \$80,000 of his own money into the initial investment.

Unbeknownst to Bentley, Barnum, Domanski, and Toy secured the services of another attorney and reincorporated under the name ENMANCO (Environmental Management Corporation), effective July 26, 1982. Domanski and Toy were Vice Presidents and Barnum was President. (See A-4). On this same date Barnum, as Enmanco's President, signed EPA Notice to Proceed Contract No. 68-95-0023 to initiate a Superfund Emergency Response cleanup action on the Liquid Disposal, Inc. (LDI) site in Utica, Michigan. It should be noted that its 1983 Annual Report filed with the State of Michigan shows that Enmanco Corp. was then an inactive corporation. (See A1, A2 & A3 attached).

Enmanco's scope of work included stabilizing the levels of the incinerator pit and scrubber lagoon, pumping and storing PCB contaminated oil, and alarming and securing the LDI site. The cleanup was completed on September 15, 1982, at which time Enmanco submitted to the EPA invoice No. 06601 in the amount of \$212,175.69.

During the progress of the LDI cleanup, Enmanco subcontracted Waste Acid Services (W.A.S.), Detroit, Michigan, to transport and dispose of hazardous waste water from the LDI incinerator pit. During the progress of the LDI cleanup, Barnum telephonically contacted Gerry Groves, W.A.S. President, around August 23, 1982 to see if W.A.S. could handle the 1,000,000 gallon incinerator pit job. Groves originally quoted between \$.07 and \$.08 a gallon to Enmanco for transportation and disposal of the incinerator pit water. W.A.S.

personnel and trucks began hauling and disposal operations on August 25, 1982 at the LDI site.

Toy as Operation's Manager supervised the loading of all W.A.S. trucks sending Groves and other W.A.S. employees to the Enmanco trailer to sign the paperwork including the Waste Disposal Manifests (Manifests) certifying gallons transported. By midmorning Toy approached Groves midway between the Enmanco trailer and incinerator pit. Toy told Groves that Groves must charge \$.25 per gallon instead of the \$.07 to \$.08 per gallon as previously discussed. Toy explained to Groves that he would now get approximately \$.11 per gallon and would receive an invoice from Enmanco for their "commission" on the deal. Both Toy and Domanski hand carried the three false invoices with supporting work sheets to Groves at W.A.S. Groves had check No. 106063 dated September 16, 1982 in the amount of \$25,041.25 made payable to Enmanco. (See B-1 to B-19).

During their last day on the LDI site, W.A.S. hauled three empty tanker truck loads which were manifested as full loads by Enmanco on the waste disposal manifests. Groves himself transported the first empty tanker load of 9,500 gallons. W.A.S. drivers Mark Groves and Gary Kulchar each transported an empty 8,000 gallon tanker truck load manifested as full by Enmanco. When Groves returned to the LDI site "mad as hell" and confronted Toy about the empty loads, Toy responded that the incinerator pit was getting low and we (Enmanco) won't make our day. Later that evening at LDI,

Groves confronted Barnum about the empty loads. Barnum walked away from Groves responding, "I don't want to hear it."

On June 18, 1984, Barnum, Domanski, and Toy met with Groves for lunch in an effort to keep the conspiracy from being discovered. They instructed Groves that they must keep their stories straight about the \$25,041.25 check, false invoices, and empty loads.

During this time period, Enmanco employees were also transporting incinerator pit water to W.A.S. for disposal in Enmanco trucks. During loading operations Enmanco employees Douglas Duynslager, Robert Bobrowski, and Darrel Van Tassel were instructed by Toy when to pump Enmanco trucks half full.

Toy would stand midway between the Enmanco trailer and the incinerator pit giving hand signals specifying half empty loads for the trucks being filled. The paperwork including waste disposal manifests for these partial loads were prepared by Domanski. Wyman Johnston, Enmanco driver, transported several partial loads to W.A.S. declaring only enough liquid was pumped into his truck to keep the front wheels down. Johnston estimated that Enmanco falsely manifested 100,000 gallons of hazardous waste that was never hauled. He heard Toy and Domanski bragging how they had ripped off the government. (See C-1 to C-3).

During the 1982 cleanup by Enmanco, Domanski prepared daily the EPA Form 1900-55's which were supposed to reflect specific services rendered and costs incurred by Enmanco in

connection with the hazardous waste cleanup of the LDI site. These 1900-55s were false because the waste disposal manifests, actual number of gallons disposed of, and the \$25,041.25 kickback from W.A.S. were included on them in support of Enmanco's final invoice to U.S. EPA. Enmanco billed the government \$.28 per gallon for the 278,700 gallons disposed of at W.A.S.

In addition, Barnum, Toy, and Domanski submitted false labor charges on the 1900-55's and on the invoice to EPA for costs incurred by Enmanco on the LDI site. The labor costs were false because many of the services which were billed to EPA were also billed to others customers of Enmanco for the same employees working at the same time, and because the hourly labor rate listed on the form 1900-55's for the employees was much higher than the amounts the employees actually received. Wyman "Jack" Johnston, Larry R. Nelson, Darrel Van Tassel, and Robert Bobrowski were Enmanco employees with services billed to LDI and other customers simultaneously. Not only did Enmanco employees receive substandard wages, but Barnum, Domanski, and Toy did not provide health care insurance, paid holidays, or other fringe benefits as claimed in the hourly labor rates. (See D-1 to D-60). Enmanco refused to allow its employees to don new paper protective suits daily or to change the cartridges in the respirators as needed when in contact with the hazardous waste.

When Enmanco was awarded the second Notice to Proceed Contract No. 68-95-0026 on April 22, 1983 through October 22, 1983 for a second "Superfund" cleanup at the LDI site, Barnum, Toy, and Domanski continued the conspiracy to defraud the government in the same manner as during contract No. 68-95-0023. The scope of the second cleanup was much greater involving the transportation and disposal of liquid waste from the LDI ponds, removal of contaminated sludge and the final capping of the LDI scrubber lagoon and incinerator pit with clay. During the period of this second LDI cleanup, Barnum, Toy, and Domanski hired Maes Trucking to transport sludge from LDI to Wayne Disposal. When Enmanco obtained a source of free clay, they directed Maes Trucking to transport the clay to the LDI site. Darwin Maes quoted a \$1.00 a yard price transportation cost to Enmanco for the clay. Barnum, Toy, and Domanski directed Maes to bill Enmanco \$2.00 a yard transportation cost and kickback \$1.00 per yard to Enmanco. Barnum, Toy, and Domanski received a total of \$11,355.00 from Maes Trucking as part of this kickback scheme. (See E-1 to E-28).

Barnum, Toy, and Domanski continued to submit false labor charges on 1900-55's and invoices to the government in the same manner as the first LDI contract. Darrell Van Tassel, James Barnum, Paul Bourdeau, Robert Bobrowski, Ron Kendall, Toy, and J. Bruflodt were Enmanco employees whose time was being billed to other customers and EPA simultaneously. Again, Barnum, Toy, and Domanski inflated the hourly

labor rate on the 1900-55's for their employees ignoring the Service Act stipulations accompanying both contracts. (See F-1 to F-72).

On one occasion Enmanco employee Gary Holleran noticed some 1900-55's which Domanski had prepared in the Enmanco trailer claiming \$18.00 and \$25.00 an hour labor charges. Holleran was surprised in view of his hourly wage of \$5.50. Often Enmanco employees Paul Bobrowski, Phil Bourdeau, Dan Dubrod, and Jerry Barr were instructed by Toy or Domanski to sit in the Enmanco ambulance on the LDI site and do nothing all day. The idle time spent in the ambulance was being charged to the EPA cleanup by Enmanco.

When Richard Benson, General Manager of Marine Pollution Control (also a contractor on the LDI site) asked Enmanco how they circumvented the government guidelines stipulating the hourly wage, Barnum explained that regulations outlined in the contract did not apply to them. Barnum promised to provide details to Benson but failed to substantiate his previous statements on wages.

Over a period from July 26, 1982 through October 29, 1983, James Barnum, Gary Domanski, and Dan Toy knowingly and wilfully falsified waste disposal manifests, EPA Forms 1900-55's, and the following invoices sent to the government:

1. Enmanco Invoice No. 6601 dated 9/28/82 for \$244,944.07. (See G-1 to G-5).
2. Enmanco Invoice No. 6900 dated 5/16/83 for \$47,300.46. (See H-1 to H-3).

3. Enmanco Invoice No. 6936 dated 6/3/83 for \$212,175.69.
(See I-1 to I-6).
4. Enmanco Invoice No. 6970 dated 7/2/83 for \$164,737.67.
(See J-1 to J-5).
5. Enmanco Invoice No. 7015 dated 8/3/83 for \$216,789.67.
(See K-1 to K-5).
6. Enmanco Invoice No. 7060 dated 9/7/83 for \$271,705.92.
(See L-1 to L-5).
7. Enmanco Invoice No. 7121 dated 10/10/83 for \$282,251.89.
(See M-1 to M-6).
8. Enmanco Invoice No. 7194 dated 11/17/83 for \$6,960.25.
(See N-1 to N-4).

LOSS TO THE GOVERNMENT

The government estimates its loss suffered as a result of this crime to be approximately \$146,988.45. That figure was computed as follows:

1. Labor - \$70,856.20 - 4,293 hours of labor multiplied by \$6.00 and subtracted from the total labor bill of \$96,656.20. This total is conservative because it does not include the billings for hours worked for other EnManCo customers and because the actual labor cost per hour was usually more than \$6.00 less than the amount billed to the government and because it does not include overtime.
2. W.A.S. kickback - \$25,041.25
3. Maes kickback - \$11,355.00
4. Three empty loads - \$7,140.00 - (25,000 gallons x \$0.28)
5. 100,000 gallons in partial loads - \$28,000.00 - (Estimates of unhailed gallons included in partial loads x \$0.28).
6. Inflated cost of 153,200 gallons hauled - \$4,596.00 - (\$0.03 x gallons actually hauled due to inflated cost of hauling and processing by W.A.S. as part of kickback arrangement).

Restitution for the loss would be appropriate as part of
any sentence imposed in this case. 18 U.S.C. §3579.

:

Respectfully submitted,

ROY C. HAYES
United States Attorney

James L. McCarthy
JAMES L. MCCARTHY (P25198)
Assistant United States Attorney

Dated: 11/8/85

CERTIFICATE OF SERVICE

It is hereby certified that service of the Government's
Sentencing Memorandum has this 8th day of November, 1985
been made upon the following by placing same in a government
franked envelope and depositing said envelope in the
United States mail addressed to:

Neil H. Fink, Esq.
1028 Buhl Building
Detroit, MI 48226

David Steingold, Esq.
1028 Buhl Building
Detroit, MI 48226

David F. Dumouchel
1930 Buhl Building
Detroit, MI 48226

Esther M. Pakauskas

Esther M. Pakauskas, Secretary
US Attorney's Office

What to Look for In Financial Statements

SAMPLE COMPANY, INC.

BALANCE SHEET

YEAR ENDED 12/31/7X

ASSETS

CURRENT ASSETS:

| | | | |
|-----|-------------------------------------------|---------------|-----------|
| 1) | CASH ON HAND | \$ 100 | |
| 2) | CASH IN BANK, CHECKING | (10,000) | |
| 3) | CASH IN BANK, PAYROLL | 5,000 | |
| 4) | CASH IN BANK, TRUST ACCOUNT | 2,000 | |
| 5) | CASH IN BANK, SAVINGS | <u>5,000</u> | |
| | TOTAL CASH | | \$ 2,100 |
| | MARKETABLE SECURITIES, A Co. | | |
| 6) | (AT COST, MARKET VALUE \$50,000) | \$ 25,000 | |
| | MARKETABLE SECURITIES, B Co. | | |
| 7) | (AT COST, MARKET VALUE \$20,000) | <u>25,000</u> | |
| | TOTAL MARKETABLE SECURITIES | | 50,000 |
| 8) | ACCOUNTS RECEIVABLE, TRADE, NET \$ 25,000 | | |
| | ACCOUNTS RECEIVABLE, | | |
| 9) | EMPLOYEES AND OFFICERS | 2,500 | |
| 9) | ACCOUNTS RECEIVABLE, STOCKHOLDERS | 1,500 | |
| 9) | ACCOUNTS RECEIVABLE, AFFILIATES | 5,000 | |
| 10) | ACCOUNTS RECEIVABLE, OTHER | <u>5,000</u> | |
| | TOTAL ACCOUNTS RECEIVABLE | | 39,000 |
| 11) | INVENTORY | | 67,500 |
| 12) | PREPAID EXPENSES | <u>1,000</u> | |
| | TOTAL CURRENT ASSETS | | \$159,600 |

OTHER ASSETS:

| | | | |
|-----|-----------------------|-------------------|----------|
| 13) | NOTES RECEIVABLE | \$ 10,000 | |
| 14) | INVESTMENT, OTHER Co. | 100,000 | |
| | (EQUITY BASIS) | <u> </u> | |
| | TOTAL OTHER ASSETS | | \$110,00 |

FIXED ASSETS:

| | | | |
|-----|--------------------------------|-----------------|-----------|
| 15) | LAND | | \$ 40,000 |
| 16) | BUILDING | \$ 60,000 | |
| 17) | LESS: ACCUMULATED DEPRECIATION | <u>(30,000)</u> | 30,000 |
| | EQUIPMENT AND AUTOS | \$100,000 | |
| 17) | LESS: ACCUMULATED DEPRECIATION | <u>(40,000)</u> | 60,000 |
| 18) | LEASEHOLD IMPROVEMENT | \$ 10,000 | |
| 17) | LESS: ACCUMULATED DEPRECIATION | <u>(1,000)</u> | 9,000 |
| 19) | MINERAL DEPOSITS | \$150,000 | |
| 20) | LESS: ACCUMULATED DEPLETION | <u>(15,000)</u> | 135,000 |
| 19) | STANDING TIMBER | \$135,000 | |
| 20) | LESS: ACCUMULATED DEPLETION | <u>(20,000)</u> | 115,000 |
| 21) | PATENTS | \$ 500 | |
| 22) | LESS: AMORTIZATION | <u>(300)</u> | 200 |

SAMPLE COMPANY, INC.
BALANCE SHEET
YEAR ENDED 12/31/7X

ASSETS (CONTINUED)

FIXED ASSETS (CONTINUED):

| | | | |
|------|-------------------------------|-----------|-----------|
| (23) | RESEARCH AND DEVELOPMENT COST | \$ 10,000 | |
| (24) | TRADE NAME AND TRADEMARK | 1 | |
| (25) | ORGANIZATION COSTS | 500 | |
| (26) | DEFERRED CHARGES | 3,500 | |
| (27) | SUSPENSE | 4,500 | |
| (28) | GOODWILL | 100,000 | |
| | TOTAL FIXED ASSETS | | \$507,701 |
| | TOTAL ASSETS | | \$777,301 |

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

| | | |
|-----------------------------------|-----------|-----------|
| ACCRUED CHARGES | \$ 55,000 | |
| ACCOUNTS PAYABLE (TRADE) | 95,000 | |
| PAYROLL TAXES PAYABLE | 35,000 | |
| PROPERTY TAXES PAYABLE | 15,000 | |
| CURRENT PORTION OF LONG-TERM DEBT | 20,000 | |
| TOTAL CURRENT LIABILITIES | | \$220,000 |

OTHER LIABILITIES 110,000

LONG-TERM LIABILITIES

| | | | |
|-----|----------------------------------------|-----------|-----------|
| (C) | BANK NOTES, 8 1/2% INTEREST | \$ 50,000 | |
| (D) | TRUST DEED, 12% INTEREST, DUE 12/31/82 | 85,000 | |
| | TOTAL LONG TERM LIABILITIES | | \$135,000 |
| | TOTAL LIABILITIES | | \$465,000 |

STOCKHOLDERS' EQUITY

| | | | |
|-----|--------------------------------------------|------------|-----------|
| (E) | COMMON STOCK, ISSUED AND OUTSTANDING | | |
| | 200,000 SHARES, AUTHORIZED 500,000 | 200,000 | |
| (E) | PAID IN CAPITAL IN EXCESS OF PAR VALUE | 150,000 | |
| | RETAINED DEFICIT, BEGINNING BALANCE | \$ (1,000) | |
| | LESS: CURRENT YEAR OPERATING LOSS | (19,699) | |
| (F) | LESS: CURRENT YEAR DIVIDENDS PAID | (17,000) | |
| (F) | RETAINED DEFICIT, ENDING BALANCE | (37,699) | |
| | TOTAL STOCKHOLDERS' EQUITY | | \$332,301 |
| | TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | | \$777,301 |

*Detection of Fraud by
Financial Statement Analysis
Case*

1. **WATCH OUT FOR EMBEZZLEMENT HERE. LOOK AT PETTY CASH VOUCHERS FOR PROPER AUTHORIZATION AND REASONABLENESS OF DISBURSEMENTS. MAKE SURE ALL THE VOUCHERS ARE PRESENT. WATCH OUT FOR FREQUENT REIMBURSEMENT OR LARGE EXPENDITURES JUST BEFORE WEEKENDS.**

2. **SOMETHING IS VERY WRONG HERE. THERE MAY BE SOME ARRANGEMENT WITH THE BANK TO HONOR NSF CHECKS. CHECK BANK STATEMENT TO DETERMINE THIS. OR THE COMPANY MAY BE WRITING CHECKS BUT NOT SENDING THEM OUT - TAKE A LOOK AT A BANK RECONCILIATION TO SEE IF THERE ARE LARGE NUMBERS OF OUTSTANDING CHECKS. IF AN OWNER OR OFFICER IS COVERING DEFICITS WITH PERSONAL FUNDS, THE STRONG DEFENSE OF COMINGLING MAY BE CREATED.**

3. **THE BOOK BALANCE SHOULD BE NOMINAL IF THIS CHECKING ACCOUNT SYSTEM IS FUNCTIONING PROPERLY. ALL OPERATING REVENUES SHOULD BE DEPOSITED TO THE GENERAL ACCOUNT WITH THE ONLY FUNDING OF THE PAYROLL ACCOUNT BEING GENERAL ACCOUNT CHECKS THE GENERAL CHECK WOULD BE DRAWN TO COVER NET PAYROLL. A NOMINAL BALANCE MAY BE LEFT IN THE ACCOUNT TO COVER EMERGENCIES. A BALANCE AS HIGH AS THIS MAY INDICATE A KITING SCHEME BETWEEN THE GENERAL AND PAYROLL ACCOUNT - CHECK THE DEPOSIT SLIPS AND CANCELLED CHECKS FOR EACH ACCOUNT.**

4. THIS MAY REPRESENT A NUMBER OF THINGS BUT IT IS LIKELY TO BE A DEVICE REQUIRED BY TAXING AUTHCRITIES TO ASSURE COLLECTION OF AMOUNTS OWING THEM. THE ONLY SOURCE OF FUNDS SHOULD BE GENERAL FUND CHECKS AND THE ACCOUNT BALANCE SHOULD BE ZERO AFTER EACH REMITTANCE. THIS COULD BE A PRELUDE TO A BANKRUPTCY IF THE COMPANY HAS BEEN MISSING PAYMENTS TO TAXING AUTHORITIES. ALSO CHECK TO SEE THAT ALL REMITTANCES FROM THIS ACCOUNT GO ONLY TO THE TAXING AUTHORITY IF IT WAS, IN FACT, SET UP FOR THIS PURPOSE.
5. NOTHING SUSPICIOUS ABOUT THIS ACCOUNT PER SE BUT IT SEEMS UNLIKELY THAT THE COMPANY WOULD HAVE A DEFICIT IN GENERAL CHECKING AND STILL HAVE A SAVINGS ACCOUNT. THIS MONEY MAY NOT ACTUALLY BE AVAILABLE TO THE BUSINESS BECAUSE IT IS SECURING SOME DEBT OR BECAUSE IT HAS BEEN DIVERTED TO PRIVATE USE. CHECK THE GENERAL JOURNAL/LEDGER FOR HISTORY OF ACTIVITY IN THIS ACCOUNT AND SOME CLUE WHERE TO GO NEXT.
6. O.K. - SECURITY IS RECORDED AT HISTORICAL COST WHICH IS PROPER. THE POSITION ON THE BALANCE SHEET INDICATES THIS SECURITY HAS A READY MARKET AND THE COMPANY WOULD SUFFER NO DETRIMENT WERE IT TO DIVEST ITSELF OF THE SECURITY. THERE MAY BE SOME QUESTION WHY IT IS NOT BEING SOLD SINCE THE COMPANY SEEMS TO BE EXPERIENCING SOME CASH FLOW DIFFICULTY AND THIS "NEAR CASH" ASSET COULD BE READILY CONVERTED TO CASH.

7. THE HISTORICAL COST IS NOT THE CORRECT AMOUNT. FOR THE SAKE OF CONSERVATISM, ALL ASSETS ARE SHOWN AT THE LOWER OF EITHER HISTORICAL COST OR MARKET VALUE. THE DECREASE IN VALUE SHOULD BE CONSIDERED PERMANENT BEFORE THE WRITE-DOWN IS ACCOMPLISHED BECAUSE ONCE IT IS WRITTEN DOWN, ACCOUNTING PRINCIPLE REQUIRES THAT IT NEVER BE WRITTEN UP AGAIN. IN THIS CASE, BOTH ASSETS AND EQUITY ARE OVERSTATED AND MAY GIVE A FALSE IMPRESSION AS TO CREDIT-WORTHINESS.
8. THE PROPER USE OF THIS ACCOUNT IS TO RECORD AMOUNTS OWING TO THE COMPANY FROM OUTSIDERS WHO HAVE BOUGHT ITS GOODS AND SERVICES. TAKE CAUTION HERE: A LOT OF NON-TRADE RECEIVABLES MAY BE BURIED ILLEGITIMATELY HERE. TAKE A LOOK AT THE GENERAL JOURNAL/LEDGER FOR A HISTORY OF THIS ACCOUNT'S ACTIVITY. IF YOU FIND LOANS BEING MADE TO EMPLOYEES, OFFICERS, STOCKHOLDERS OR AFFILIATED COMPANIES, WATCH OUT FOR A CREDITOR RIP-OFF. CLUES TO SUCH A FRAUD MIGHT BE (1) A SIGNIFICANT INCREASE IN ACCOUNTS PAYABLE; (2) A SIGNIFICANT DECREASE IN INVENTORY COMBINED WITH A LEVEL OR SLIGHTLY INCREASING BALANCE IN ACCOUNTS PAYABLE; (3) INCREASED LONG TERM DEBT; (4) OTHER DIVERSION OF MONEY SUCH AS DIVIDENDS OR PAYMENT OF INTEREST ON SUBORDINATED DEBT; (5) HIGH DEBT RATIO. THE PRESENCE OF ACCOUNTS

RECEIVABLE INDICATES THAT THE COMPANY IS ON THE ACCRUAL BASIS OF ACCOUNTING RATHER THAN THE CASH BASIS. THAT IS, THE SALE IS RECOGNIZED WHEN IT IS SUBSTANTIALLY EXECUTED RATHER THAN WHEN CASH IS COLLECTED. "NET" INDICATES THAT SOME PROVISION HAS BEEN MADE IN THE RECORDS ANTICIPATING BAD DEBTS. CHECK FOR REASONABLENESS OF THE WRITE-OFF BECAUSE IT IS TAX DEDUCTIBLE AND IT IS NOT USUALLY SELF-CORRECTING FOR PRIOR YEAR ERRORS. RECOGNITION OF BAD DEBTS IS PROPER WHEN THE COMPANY IS ON THE ACCRUAL BASIS.

9. THE EXISTENCE OF ANY OF THESE ACCOUNTS IN COMBINATION WITH A POOR CASH FLOW AND/OR HIGH DEBT RATIO SIGNALS A CREDITOR RIP-OFF OR BANKRUPTCY SCHEME. CHECK GENERAL JOURNAL/LEDGER FOR A HISTORY OF ACTIVITY IN THESE ACCOUNTS AND LOOK AT CANCELLED CHECKS TO PINPOINT A DIVERSION OF CASH.
10. THIS ACCOUNT MAY BE SIGNIFICANT IN RELATION TO THE OTHER ACCOUNTS. ITS PROPER USE REFLECTS AMOUNTS DUE FROM NON-TRADE DEBTORS; IMPROPERLY, IT IS USED TO BURY DEBT THAT WOULD BE INCRIMINATING IF LISTED SEPARATELY. IF THE BALANCE SHEET BREAKS OUT AS MANY KINDS OF RECEIVABLES IN DETAIL AS THIS EXAMPLE, SOMETHING IS PROBABLY BURIED HERE WHICH WOULD SIGNAL DIVERSION OF FUNDS. TAKE A LOOK AT THE GENERAL JOURNAL/LEDGER FOR A HISTORY OF ACTIVITY IN THIS ACCOUNT AND A CLUE WHERE TO GO NEXT.

11. INVENTORY IS VERY VULNERABLE TO THEFT. INVENTORY MAY ALSO BE WORTHLESS OR NON-EXISTENT. PHYSICAL VERIFICATION OR COUNT IS YOUR BEST BET BECAUSE IT MAY STILL BE CARRIED ON THE BOOKS AT THE LOWER OF COST OR MARKET.

INVENTORY SHOULD BE VALUED AT ITS HISTORICAL COST OR ITS MARKET VALUE, WHICHEVER IS LESS. HISTORICAL COST WOULD BE THE PURCHASE PRICE OR THE FULL COST OF MANUFACTURE INCLUDING OVERHEAD. HOWEVER, BE ON THE LOOKOUT FOR VALUATIONS INCLUDING ESTIMATION, APPRAISAL AND RETAIL SALES PRICE WHICH WOULD OVERSTATE THE ASSETS AND MIGHT GIVE A FALSELY ROSY PICTURE TO CREDITORS. THE VALUATION PROBLEM IS FURTHER COMPOUNDED BY ASSUMPTIONS REGARDING THE PHYSICAL FLOW OF MERCHANDISE. SPECIFIC IDENTIFICATION OF ITEMS SOLD AND REMOVAL OF THE INDIVIDUAL COSTS ASSOCIATED WITH THOSE ITEMS IS IDEAL BUT RARELY FEASIBLE (THE ITEMS HAVE TO BE UNIQUELY AND READILY IDENTIFIABLE AND THE UNIT COST MUST BE RELATIVELY HIGH). ABANDONING SPECIFIC IDENTIFICATION, THE MOST COMMON FLOW ASSUMPTIONS ARE:

- (1) FIFO: FIRST-IN, FIRST-OUT
- (2) LIFO: LAST-IN, FIRST-OUT
- (3) WEIGHTED AVERAGE: GOODS MOVE OUT IN RELATION TO THE SIZE OF THE LOT PUT INTO INVENTORY.

VARIATIONS IN VALUATION AND FLOW ASSUMPTION CAN LEAD TO MANIPULATION OF INCOME - ACCOUNTANTS REQUIRE THAT THE SAME TECHNIQUES BE USED FROM YEAR TO YEAR IN A CONSISTENT MANNER. TRY TO GET HOLD OF COST WORKSHEETS PREPARED BY THE COMPANY'S ACCOUNTANT TO DETERMINE PROCEDURES BEING USED.

12. APPEARS TO BE O.K. RECORDS ONLY EXPENDITURES FOR SUCH ITEMS AS RENT, INSURANCE AND INTEREST THAT ARE PAID IN ADVANCE, PARTICULARLY WHERE BENEFIT IS LONGER THAN THE CURRENT ACCOUNTING PERIOD. IF THERE SEEMS TO BE A LOT OF MANIPULATION IN THE BOOKS, TAKE A LOOK AT THE GENERAL JOURNAL/LEDGER TO GET AN IDEA OF THE ACTIVITY IN THE ACCOUNT.
13. THE MOST REPUTABLE USE OF NOTES RECEIVABLE WOULD INDICATE THE REPLACEMENT OF AN OVERDUE TRADE ACCOUNT RECEIVABLE WITH A MORE FORMAL NOTE, USUALLY INTEREST BEARING. HOWEVER, THIS COULD BE A HIDING PLACE FOR LOANS TO OFFICERS, EMPLOYEES, STOCKHOLDERS OR AFFILIATES WHICH ARE NEITHER FORMAL NOR INTEREST BEARING. IF THE AMOUNT IS SUBSTANTIAL OR IF THERE IS OTHER EVIDENCE OF DIVERSION OF COMPANY FUNDS TRACE THE TRANSACTIONS TO THE GENERAL JOURNAL/LEDGER AND GET A CLUE WHERE TO GO NEXT. WATCH OUT - THERE IS A F
LIKELIHOOD THESE NOTES ARE UNCOLLECTIBLE, ESPECIALLY
THEY ARE NOT CLASSIFIED AS CURRENT ASSETS.

14. THIS REPRESENTS THE COST OF ACQUIRING AN AFFILIATE COMPANY AND THE ACQUIRING COMPANY'S SUBSEQUENT SHARE OF EARNINGS. THIS DOES NOT REPRESENT A MARKETABLE SECURITY BECAUSE THE ACQUIRING COMPANY WOULD SUFFER ECONOMIC DETRIMENT WERE IT TO DIVEST ITSELF OF THE AFFILIATE - THAT IS, THE WHOLE IS PROBABLY GREATER THAN THE SUM OF ITS PARTS.
15. THE ONLY ACCEPTABLE BASIS FOR LAND ON THE BALANCE SHEET IS THE LOWER OF HISTORICAL COST OR MARKET VALUE. FOR ALL PURPOSES, LAND IS VALUED AT COST BECAUSE THE DECLINE IN MARKET VALUE MUST BE CONSIDERED PERMANENT. LAND DOES NOT DEPRECIATE - IT IS NOT CONSUMED IN THE COURSE OF NORMAL OPERATIONS. IT IS NOT PROPER TO RECOGNIZE ANY APPRECIATION PRIOR TO THE TIME OF THE SALE OF LAND. CHECK THE GENERAL JOURNAL/LEDGER TO BE SURE THAT ANY CHANGES ON THE BALANCE SHEET OCCUR ONLY FROM THE SALE OR PURCHASE OF LAND.
16. THE ONLY ACCEPTABLE BASIS FOR ANY FIXED ASSET IS THE LOWER OF COST OR MARKET VALUE. ANY DECLINE IN MARKET VALUE MUST BE CONSIDERED PERMANENT BEFORE IT IS REFLECTED IN THE BOOKS BECAUSE IT MAY NEVER BE WRITTEN UP AGAIN. IT IS NOT PROPER TO REFLECT ANY APPRECIATION IN VALUE.

WATCH OUT FOR ANY WRITE UP IN VALUE - IT'S A WAY OF
CREATING CAPITAL IN AN IMPROPER AND RISKY MANNER.

PLANT AND EQUIPMENT-LIKE BUILDINGS, MANUFACTURING EQUIPMENT, TRANSPORTATION EQUIPMENT AND FURNISHINGS ARE DEPRECIABLE. AN ASSET CAN BE THOUGHT OF AS THE FUTURE SERVICE VALUE AVAILABLE TO THE OWNER OR USER OF THE ASSET. DEPRECIATION IS A REFLECTION OF THE SERVICE VALUE CONSUMED BY THE OWNER OR USER DURING THE ACCOUNTING PERIOD; THAT IS, THE BOOKS ARE MADE TO REFLECT THE REDUCTION IN FUTURE SERVICE VALUE DUE TO CURRENT USE OF THE ASSET IN BUSINESS OPERATIONS.

17. ACCUMULATED DEPRECIATION IS THE SUM TOTAL OF ALL THE DEPRECIATION TAKEN ON PLANT AND EQUIPMENT DURING PRIOR YEARS OF SERVICE. WHEN IT IS DEDUCTED FROM THE COST OF THE ASSET, THE RESIDUAL IS KNOWN AS "BOOK VALUE" AND REPRESENTS THE FUTURE SERVICE VALUE STILL AVAILABLE. BECAUSE DEPRECIATION IS ONLY AN ESTIMATE, IT IS SUBJECT BOTH TO ERROR AND TO CONSCIOUS MANIPULATION. IRS PUBLISHES GUIDELINES FOR MANY TYPES OF ASSETS - CONSULT THIS TO GET A BALLPARK AREA. WATCH OUT FOR SALES OF PLANT AND EQUIPMENT BEING RECORDED IN ACCUMULATED DEPRECIATION - THE EFFECT IS TO LEAVE AN UNDEPRECIATED ASSET ON THE BOOKS

WHICH THE COMPANY NO LONGER OWNS. BOTH ASSETS AND CAPITAL WOULD BE OVERSTATED IN THIS CASE.

18. THIS ONE INDICATES TROUBLE NINE TIMES OUT OF TEN. THIS COMPANY HAS AT LEAST ONE LEASE CONTRACT OUTSTANDING, BUT THERE IS VERY LIKELY NO RECOGNITION AT ALL OF THE CORRESPONDING LIABILITY OR OBLIGATION TO PAY. YOU MAY FIND MENTION OF THE PAYMENT TERMS IN A FOOTNOTE BUT THE POPULAR TREATMENT IS TO IGNORE IT.
19. MINERAL DEPOSITS AND STANDING TIMBER ARE BOTH NATURAL RESOURCES WHICH ARE SUBJECT TO EXHAUSTION BY EXTRACTION. THEY ARE CATEGORIZED AS WASTING ASSETS THAT ARE LARGE-SCALE, LONG-TERM INVESTMENTS ACQUIRED FOR PIECE-MEAL RESALE OR USE IN PRODUCTION. CAUTION: THIS ITEM MAY BE DOUBLE-COUNTED ON THE BALANCE SHEET. BE SURE THAT THE UNEXTRACTED RESOURCE IS NOT ALSO INCLUDED IN INVENTORY. THE INVENTORY SHOULD INCLUDE ONLY HARVESTED SUPPLIES READY FOR RESALE OR USE IN PRODUCTION. THE INVESTMENT SHOULD INCLUDE ONLY UNPROCESSED ASSETS.

THE ONLY ACCEPTABLE BASIS FOR THE INVESTMENT IS THE LOWER OF HISTORICAL COST OR MARKET VALUE.

20. WASTING ASSETS ARE SUBJECT TO "DEPLETION." DEPLETION, LIKE DEPRECIATION, IS A REFLECTION OF THE SERVICE VALUE CONSUMED BY THE OWNER OR USER DURING THE ACCOUNTING PERIOD. ACCUMULATED DEPLETION IS THE SUM TOTAL OF ALL THE DEPLETION RECOGNIZED DURING PRIOR YEARS OF SERVICE. THE SAME CAUTIONS WITH RESPECT TO ACCUMULATED DEPRECIATION HOLD TRUE HERE.

21. A PATENT OR COPYRIGHT IS AN "INTANGIBLE ASSET" WHICH HAS ECONOMIC VALUE ONLY IF IT AFFORDS PROTECTION AGAINST COMPETITION, PRODUCES INCREASED EARNINGS BECAUSE OF LOWER PRODUCTION COSTS, OR ENABLES THE COMPANY TO CHARGE A HIGHER PRICE FOR THE COMMODITY. FOR ALL PRACTICAL PURPOSES, THE ONLY ACCEPTABLE BASIS FOR THE PATENT IS HISTORICAL COST, EITHER PURCHASE PRICE OR DIRECTLY RELEVANT EXPENDITURES IF THE PATENT IS DEVELOPED. MOST COMPANIES PREFER TO CHARGE OFF RESEARCH AND DEVELOPMENT OF PATENTS IN THE YEAR OF EXPENDITURE RESULTING IN A VERY NOMINAL CAPITALIZATION. A LARGE AMOUNT ATTRIBUTED TO PATENTS SHOULD BE INVESTIGATED USING THE COMPANY'S COST WORKSHEETS OR THE PURCHASE CONTRACT.

ALTHOUGH THERE IS A STIPULATED LEGAL LIFE, THE ECONOMIC LIFE IS GENERALLY SHORTER AND THE ASSET SHOULD BE WRITTEN OFF OVER THE USEFUL ECONOMIC LIFE. "AMORTIZATION"

IS THE TERM APPLIED TO THE WRITE OFF WHICH IS
SIMILAR TO DEPRECIATION OR DEPLETION.

22. AMORTIZATION IS THE WRITE OFF OF AN INTANGIBLE ASSET AS IT IS CONSUMED BY THE BUSINESS IN THE PRODUCTION OF REVENUE. THE SAME CAUTIONS APPLY HERE AS TO DEPRECIATION.
23. MANY COMPANIES SPEND HUGE SUMS ON DISCOVERING AND DEVELOPING NEW PRODUCTS AND PROCEDURES. WHEN A MARKET-ABLE PRODUCT IS OBTAINED, AN INTANGIBLE ASSET IS CREATED. ALTHOUGH UNPRODUCTIVE AVENUES YIELD INCREASED GENERAL KNOWLEDGE, ONLY THOSE RESEARCH PROJECTS WHICH YIELD ECONOMIC VALUE DIRECTLY SHOULD BE CAPITALIZED. BECAUSE THE ONLY ACCEPTABLE BASIS IS HISTORICAL COST, WHICH IS HARD TO DETERMINE, THE POPULAR TREATMENT IS TO WRITE OFF R & D COSTS IN THE YEAR INCURRED. IN MOST CASES, THE CAPITALIZED AMOUNT SHOULD BE NOMINAL AND INTENDED ONLY TO INFORM READERS AND R & D IS AN IMPORTANT PART OF THE BUSINESS.
24. DON'T LET THE DOLLAR FOOL YOU! THIS IS PERFECTLY ACCEPTABLE ACCOUNTING PROCEDURE FOR AN INTANGIBLE ASSET. IT IS USED AS A DEVICE TO CLUE YOU TO THE EXISTENCE OF THIS ASSET - REGARDLESS OF THE HISTORICAL COST. THE

ECONOMIC VALUE OF THIS ASSET STEMS FROM PRODUCT IDENTIFICATION AND DIFFERENTIATION WHICH YIELD SUPERIOR EARNINGS TO UNBRANDED PRODUCTS. THESE PROPERTY RIGHTS MAY BE LEASED, ASSIGNED OR SOLD AND THE SERVICE LIFE IS UNLIMITED SO LONG AS THEY ARE USED AND YIELD SUPERIOR EARNINGS. IF THE BOOK VALUE OF THIS ASSET IS RELATIVELY HIGH, BE SUSPICIOUS. TRY TO SEE WORKSHEETS DETAILING WHAT IS INCLUDED HERE. ADVERTISING IS NOT USUALLY CAPITALIZED BECAUSE OF THE NEBULOUS RELATIONSHIP WITH SUPERIOR EARNINGS.

25. "ORGANIZATION" OR "START-UP" COSTS ARE SYNONYMOUS AND REFER TO THE FUTURE SERVICE VALUE DERIVED FROM ORIGINATING THE BUSINESS. THE USUAL ITEMS WHICH ARE CAPITALIZED ARE LEGAL AND ACCOUNTING FEES AND INITIAL STOCKHOLDER MEETINGS. USED PROPERLY, THE BALANCE IN THE ACCOUNT SHOULD BE NOMINAL. USED IMPROPERLY, THIS IS A GOOD PLACE TO BURY EARLY OPERATING LOSSES. IF THE BALANCE SEEMS TOO HIGH, TAKE A LOOK AT THE GENERAL JOURNAL/LEDGER FOR DETAILED HISTORY OF THE ACCOUNT. THEORETICALLY, THE COSTS HAVE A SERVICE LIFE AS LONG AS THAT OF THE BUSINESS, BUT IRS ENCOURAGES RAPID WRITE OFF.

26. "DEFERRED CHARGE" IS AT BEST A DUBIOUS ACCOUNT AND WILL PROBABLY NEED A PROFESSIONAL ACCOUNTANT TO DECIPHER WHAT IS GOING ON IN THE ACCOUNT. ALTHOUGH THERE ARE SOME LEGITIMATE USES OF THE ACCOUNT, ALMOST NO ONE USES THEM PROPERLY. A COMMON USE OF THE ACCOUNT IS MAKING THE BOOKS BALANCE, BUT EVEN BRIBES MAY BE FOUND HERE.
27. THIS IS NOT A LEGITIMATE ACCOUNT! IT CAN BE USED AS AN ACCOUNTANT'S TOOL, BUT IT CAN NEVER BE USED ON THE FINANCIAL STATEMENT. USE THE GENERAL JOURNAL/ LEDGER TO DETERMINE WHAT IS BURIED HERE. IT IS COMMONLY USED BY AN EMBEZZLER TO COVER CASH SHORTAGES.
28. ACCOUNTING RECOGNITION OF GOODWILL IS LIMITED AT THIS TIME TO THE RECOGNITION OF PURCHASED GOODWILL. THIS MEANS THAT THE COMPANY WAS PURCHASED AT SOME PRIOR TIME AS A GOING CONCERN AND THAT AT THE TIME OF PURCHASE THE BUYERS PAID A PREMIUM PRICE. THE PREMIUM IS RECORDED AS GOODWILL AFTER THE APPROPRIATE ASSETS HAVE BEEN WRITTEN UP (THIS IS A LEGITIMATE WRITEUP - NEW OWNERS ACQUIRE A NEW BASIS WHICH BECOMES THE HISTORICAL COST TO THEM). A COMPANY WHICH HAS NEVER BEEN SOLD CANNOT HAVE RECORDED GOODWILL. GOODWILL IS EVIDENCED

BY A RATE OF RETURN TO OWNERS IN EXCESS OF A NORMAL RATE. GOODWILL RECONCILES THIS HIGHER RATE OF RETURN BY RECONCILING THE VALUE OF THE BUSINESS AS A WHOLE WITH THE SUM OF ITS PARTS. A QUICK AND DIRTY TEST TO DETERMINE IF GOODWILL IS PROPERLY RECORDED IS CALCULATING THE RATE OF RETURN ON OWNER'S EQUITY AND COMPARING IT TO A NORMAL RATE. THE RATE WITH AN APPROPRIATE AMOUNT OF GOODWILL WILL APPROACH A NORMAL RATE OF RETURN.

GOODWILL MAY OR MAY NOT BE AMORTIZED AND ACCOUNTANTS HAVE SUBSTANTIAL ARGUMENTS FOR BOTH SIDES. CONSULT A PROFESSIONAL ACCOUNTANT IF THIS IS CAUSING PROBLEMS.

- A. CURRENT LIABILITIES ARE THOSE DEBTS WHICH FALL DUE IN ONE YEAR OR LESS FROM THE DATE OF THE FINANCIAL STATEMENT. THERE ARE SEVERAL DANGER SIGNALS TO WATCH FOR INCLUDING:

(1) INDICATIONS OF A BUILDUP IN AMOUNTS OWING TO TAXING AUTHORITIES, PARTICULARLY PAYROLL TAXES, BECAUSE THEY HAVE THE FIRST CLAIMS ON ASSETS AND USUALLY COMPANIES ARE IN VERY BAD SHAPE BEFORE THEY BECOME DELINQUENT HERE. BANKRUPTCY IS IMMINENT SO WATCH OUT FOR OTHER SIGNS OF A CREDITOR RIP-OFF LIKE DISCRETIONARY DIVERSION OF FUNDS.

(2) SIGNIFICANT INCREASES IN DEBT OUTSTANDING DURING THE CURRENT YEAR. A VAST INCREASE IN TRADE PAYABLES COMBINED WITH A DECLINE IN INVENTORY AND DECREASING SALES SIGNALS TROUBLE. CREDITORS ARE WAITING LONGER FOR PAYMENT SO KEEP LOOKING FOR DISCRETIONARY PAYMENTS IF YOU SUSPECT FRAUD.

(3) CURRENT LIABILITIES TOTALING AS MUCH OR MORE THAN CURRENT ASSETS. THIS INDICATES THE COMPANY'S ABILITY TO PAY OBLIGATIONS AS THEY FALL DUE IS SERIOUSLY IMPAIRED; THE COMPANY IS "INSOLVENT" AND IT MAY FOREWARN A BANKRUPTCY. AGAIN WATCH FOR DIVERSION OF FUNDS AWAY FROM CREDITORS.

IN THIS CASE, THERE IS INSUFFICIENT INFORMATION TO DETERMINE IF PAYROLL TAXES ARE BUILDING UP. AN INCOME STATEMENT CAN HELP IF IT LISTS THINGS SUCH AS PENALTIES AND INTEREST TO TAXING AUTHORITIES. THE GENERAL LEDGER CAN HELP DETERMINE WHEN THE LAST PAYMENT WAS MADE. THERE IS ALSO INSUFFICIENT INFORMATION TO DETERMINE IF CURRENT DEBTS ARE INCREASING RAPIDLY. COMPARATIVE FINANCIAL STATEMENTS ARE THE EASIEST WAY TO DETERMINE THIS BUT A GENERAL LEDGER WILL HELP, TOO.

WE CAN DETERMINE THAT THE COMPANY IS INSOLVENT BECAUSE CURRENT LIABILITIES GREATLY SURPASS CURRENT ASSETS AND CASH, ESPECIALLY, LOOKS INSIGNIFICANT. THE COMPANY SHOULD TRY TO COLLECT ITS NON-TRADE RECEIVABLES AND SELL ITS MARKETABLE SECURITIES. IF IT FAILS TO DO SO, BE SUSPICIOUS OF A BANKRUPTCY FRAUD.

B. BE VERY SUSPICIOUS OF ANY LIABILITY WHICH IS CLASSIFIED AS "OTHER" AND IS NEITHER CURRENT NOR LONG-TERM. THIS IS A GOOD WAY OF DISGUIISING DEBT WHICH IS MORE CLOSELY AKIN TO EQUITY AND WHICH SHOULD PROBABLY BE SUBORDINATED IN THE PAYMENT OF INTEREST, ESPECIALLY IF MANY OF THESE DEBTHOLDERS ARE ALSO SHAREHOLDERS. IF A BANKRUPTCY SCHEME OR A CREDITOR RIP-OFF IS SUSPECTED, TRY TO LOOK AT INTEREST PAYMENTS ON THIS CLASS OF DEBT IN THE GENERAL LEDGER. IT MAY BE A DIVERSION OF FUNDS IF, IN FACT, THE DEBT SHOULD BE SUBORDINATED. IF BANKRUPTCY IS PENDING, WATCH OUT FOR REPAYMENT OF THIS DEBT RATHER THAN PAYING CREDITORS WITH SUPERIOR CLAIMS.

C. THE BANK LOAN IN ITSELF SEEMS O.K. BUT IN RELATION TO THE OTHER AMOUNT OF DEBT OUTSTANDING, IT SEEMS SURPRISING THAT A BANK WOULD MAKE A LOAN TO THIS COMPANY. THE COMPANY SEEMS VERY HIGHLY LEVERAGED; THAT IS, CREDITORS HAVE SUPPLIED MORE FINANCING THAN OWNERS OF THE COMPANY.

THE USE OF LEVERAGE MAKES REPAYMENT OF LOANS, AT BEST, A RISKY SITUATION. SHRINKAGE OF ASSETS, ESPECIALLY DURING PERIODS OF LOSS, CAN AFFECT REPAYMENT AS WELL AS IMPAIRED ABILITY TO BORROW ADDITIONAL SUMS DURING TIGHT PERIODS. NOT EVEN STOCKHOLDERS BENEFIT FROM HIGH LEVERAGE BECAUSE LARGE FIXED INTEREST PAYMENTS INCREASE THE RISK OF BANKRUPTCY AND USUALLY SOME STRINGENT RESTRICTIONS ARE PLACED UPON MANAGEMENT COURSE OF ACTION. SUSPICIOUSLY HIGH LEVERAGE STARTS WHEN TOTAL DEBT EXCEEDS 50 PER CENT OF TOTAL ASSETS. THE MOST OBVIOUS EXPLANATIONS ARE (1) THE COMPANY HAS GREATLY APPRECIATED IN VALUE AND THE LOANS ARE MADE ON THIS BASIS OR (2) FALSE FINANCIAL STATEMENTS HAVE BEEN PRESENTED TO SECURE CREDIT

- D. IN ADDITION TO THE COMMENTS MADE UNDER "C" WITH RESPECT TO THE USE OF LEVERAGE, THE 12 PER CENT INTEREST RATE IS PROBABLY IN VIOLATION OF CALIFORNIA USURY LAWS.
- E. FROM THE TWO ACCOUNTS LISTED AS "COMMON STOCK" AND "PAID-CAPITAL" WE CAN DETERMINE THAT OWNERS OF THE COMPANY HAVE CONTRIBUTED \$350,000 TO THE BUSINESS, HENCE, THIS SECTION OF THE BALANCE SHEET IS TERMED "CONTRIBUTED CAPITAL." IT REFLECTS THE PAR OR STATED VALUE OF THE STOCK PLUS ANY ADDITIONAL PROCEEDS THE COMPANY RECEIVED FROM THE INITIAL ISSUANCE OF ITS STOCK. THE PAR OR STATED VALUE OF THE

STOCK MUST BE \$1 BECAUSE IT IS VALUED ON THE BALANCE SHEET AT \$200,000 FOR 200,000 SHARES. THE COMPANY ACTUALLY RECEIVED MORE THAN \$200,000 AND THE PREMIUM MUST BE LISTED SEPARATELY BY ACCOUNTING CONVENTION.

IT SEEMS A POOR POLICY TO SECURE DEBT IN THE MANNER OF THIS COMPANY WHEN THERE IS STILL STOCK THAT COULD BE ISSUED. THIS WOULD BE AN OBVIOUS REMEDY TO BOTH THE CASH FLOW PROBLEM AND THE LEVERAGE PROBLEM.

F. "RETAINED EARNINGS" OR "RETAINED DEFICIT" REFER TO THE ACCUMULATED NET PROFIT OR LOSS THAT THE COMPANY HAS INCURRED SINCE ITS INCEPTION. IN THIS CASE, AT THE BEGINNING OF THE CURRENT FISCAL YEAR, THE COMPANY HAD ALREADY SUFFERED A TOTAL LOSS OF \$1000 DURING THE PRIOR YEARS OF OPERATION. IN ADDITION, IT SUFFERED A LOSS OF \$19,699 DURING THE CURRENT YEAR WHICH IS NOT A GOOD SIGN. THE NATURE OF THE LOSS SHOULD BE DETERMINED BEFORE PROCEEDING, IF POSSIBLE. THE INCOME STATEMENT OF THE COMPANY SHOULD HELP. SUCH A LOSS COULD OCCUR BECAUSE OF DECLINING SALES, INCREASING COSTS WHICH THE CONSUMER CANNOT ABSORB, AN EXTRAORDINARY LOSS OR WRITE-OFF WHICH DOES NOT REFLECT ON ORDINARY BUSINESS OPERATIONS OR EVEN PAYMENTS OF PERSONAL EXPENSES BY THE CORPORATION.

FINALLY, THERE IS THE ISSUE OF THE PAYMENT OF
DIVIDENDS. THIS IS AN OBVIOUS AND UNJUSTIFIABLE
DIVERSION OF CASH FROM THE BUSINESS WHEN IT IS
NOT EVEN LEGALLY PERMITTED. DIVIDENDS MAY ONLY
BE PAID WHEN THERE IS RETAINED EARNINGS AVAILABLE
IN AN EQUAL AMOUNT; THAT IS, THE PAYMENT OF
DIVIDENDS MAY NEVER CAUSE THE RETAINED EARNINGS
ACCOUNT TO SLIP BELOW ZERO.

Problem No. 1

Review of Internal Control of Materials

1. You are assigned to a resident office where the contractor fabricates and installs various electronic devices on ~~Sewage Control~~ for the Government. You are given the assignment to review the internal controls for the purchase, receipt, storage, and issue of materials. You have completed your review and summarized the following comments which describe the contractor's procedures.
 - a. Most of the materials are high value electronic components which are kept in a locked storeroom. Some of the components contain gold and silver contacts and precious metal impregnated circuitry. Storeroom personnel include a supervisor and four clerks. All are well trained, competent individuals. Materials are removed from the storeroom only upon the written or oral authorization of one of the production foremen.
 - b. Occasionally, the production areas will accumulate excessive quantities of material. These excess quantities result from over requisitioning and because some of the components do not meet the electrical specifications. For security reasons, the excess quantities in the production areas are returned to the storeroom for safekeeping.
 - c. When ordered materials arrive, they are received by the storeroom clerks. The clerks count the merchandise and verify the counts to the shipper's bill of lading. All vendor's bills of lading are initialed, dated, and filed in the storeroom to serve as receiving reports.

2. Required:

Describe the weaknesses in internal control and recommended improvements for the purchasing, receipt, storage, and issue of raw materials. Organize your answer sheet as follows:

| <u>Weaknesses</u> | <u>Recommended Improvements</u> |
|-------------------|---------------------------------|
|-------------------|---------------------------------|

Problem No. 2

Review of Purchasing

1. Bill Buymore is a buyer for the Coulomb Company. Bill specializes in procurement of high value electronic parts. Because of Bill's superior knowledge and experience in electronic parts procurement, he has been the sole buyer of high value electronic parts for the past ten years. Knoll Inc., has been selected by Bill as Coulomb's high value electronic parts vendor, without exception, for the past six years. Bill instructs Knoll Inc., to ship all parts directly to him, to assure proper handling and security. Upon receipt, Bill completes all receiving and inspection documents. He personally hand carries the high value parts to a secure storage area where a material clerk updates the inventory records. Bill Buymore lives in a beach house in Costa Mesa, CA, drives a Jaguar XJS, and has just purchased a new 40 foot /acnt.
2. Required:
 - a. List all procurement fraud indicators.
 - b. Describe preventative measures that could deter procurement fraud.

Problem No. 3

Case Study - Labor Mischarges

The following is an actual case that demonstrates another technique used to manipulate labor charges.

BACKGROUND - The contractor had several Government time and material (T&M) contracts to test and evaluate gasoline generators. In addition, at the same division, the contractor had several fixed price commercial contracts. Biweekly time sheets were maintained by supervisors and signed by the employee.

HOW THE FRAUD WAS DETECTED - During an incurred cost audit, the auditor noted that the billed, booked and timesheet hours did not agree. Confronted with this situation, the auditor explained his difficulties and requested the contractor to prepare a complete reconciliation of hours billed with those on the books and timesheets. The auditor conferred with his FAO Chief and a decision was made that the auditor should withdraw from the audit.

Later, a corporate Vice-President requested a meeting with the auditor. At the meeting, the corporate officer revealed allegations made by a former division level Secretary/Treasurer relative to contract billings on the T&M contracts. The corporate officer made available various written documents (memos to file) which indicated that division level contractor representatives were involved in falsification of time sheets and related submission of false claims for services not performed. The documents showed that corporate officials had been aware of the alleged wrongdoing for two years, but had not made any disclosure prior to the meeting with the auditor. According to the allegations made by the former Secretary/Treasurer, the Government, over a six year period, was overbilled by \$500 to \$700 thousand for services not performed.

DETAILS OF THE FRAUD - The former division Secretary/Treasurer contacted the company's CPA firm and requested the services of two auditors for a 2-4 week period to assist in straightening out his books and records so he could comply with corporate reporting requirements. The CPA firm was to submit its invoice for these accounting services directly to the Secretary/Treasurer, who would approve payment. The CPA firm notified the corporate office of the Secretary/Treasurer's request because this billing procedure departed from the past practice of submitting billings for accounting services to the corporate office for approval. The CPA firm also indicated to corporate officials that the Secretary/Treasurer was incompetent. Corporate officials decided to terminate the Secretary/Treasurer because of his incompetence and the fact that he had attempted to acquire accounting assistance without their knowledge.

During the "exit interview", the Secretary/Treasurer informed corporate officials of irregularities regarding the billing procedures on the Government T&M contracts. He alleged that each month a certain

amount of time spent on commercial fixed price jobs was reallocated to Government T&M contracts. These reallocations were made at the direction of the division President to conceal the fact that the commercial work could not be accomplished within the fixed price hour budget. He alleged the following procedures were used to "adjust" time charges.

1. The computer preprinted a timesheet for each employee to use for charging his time to either an active job number or an overhead category for non-productive time. The timesheets covered the two week payroll period and were composed of three copies (copy one - original, copy two - duplicate, and copy three - pink sheet).
2. After the first week of the two week payroll period, each employee submitted his "pink sheet" for processing. The "pink sheet" was coded and processed on the computer to provide a labor distribution for the week. The labor distribution was reviewed to ascertain how many hours had been charged to T&M contracts for that week.
3. At the end of the second week, the other two copies were turned in for the full two week period, coded and processed on the computer. This processing produced another report showing the total hours charged to T&M jobs extended at the T&M hourly billing rate.
4. Division "top management" would review this report and make certain adjustments which took the form of moving time from one sub-task to another within the same contract, moving time from overhead accounts to T&M contracts, and moving time from fixed price commercial contracts to T&M contracts.
5. Once enough "adjustments" had been made to achieve a "satisfactory" billing level, the computer was used to rerun a fresh set of timesheets for that payroll period. Various clerical personnel within the accounting department would prepare new timesheets for those employees whose time had been "adjusted" to make these timesheets agree with the "adjusted" billing. After all the "new" timesheets had been prepared, the employee's signature was traced from the original timesheet submitted. All original timesheets were destroyed. The new timesheets were then coded and run on the computer to create a "new" distribution of time and an "adjusted" T&M billing. The old reports reflecting correct time charges were destroyed.

When asked how the Secretary/Treasurer was able to prevent UCAA from uncovering the scheme for overcharging the Government, he responded that whenever a A audit took place he was careful to note the timesheets examined by the auditor so that such timesheets did not become a part of the "adjusted" timesheets for that month and in that

way there were never any discrepancies between the hours on the timesheets the auditor examined and the hours billed the Government.

The division Secretary/Treasurer was terminated. The corporate office hired another Secretary/Treasurer and instructed him to report to the corporate office any irregularities noted. The new Secretary/Treasurer reported a \$10,820 overbilling during his first month of employment. However, accounting personnel indicated to him that the adjustments for that month were nowhere near as much as prior months. Based upon this information, the division President was terminated.

The corporate office obtained legal counsel and attempted to determine the extent of the overbillings. Because the records had been destroyed it was impossible to determine the exact amount. The CPA's workpapers were reviewed to determine if they would shed any light on the matter. They found no evidence of any audit work performed that would have uncovered any of the problems.

After reviewing the written documentation (memos to file), and discussing the matter with corporate officials, the auditor issued a report of suspected wrongdoing. A DCAA Form 1 suspending \$700,000 was issued. An investigation by the Department of Justice was made, resulting in a grand jury proceeding and a trial in U.S. District Court.

The contractor pleaded guilty to two counts of violation of Title 18, U.S. Code Section 287, False, Fictitious or Fraudulent Claims and was fined the maximum of \$10,000 for each count. In addition, the contractor reached a settlement with the Government totaling \$633,716 in restitution for the overcharges.

The division President was found guilty on 11 counts of violation of Title 18, U.S. Code Section 287, False, Fictitious or Fraudulent Claims and was sentenced to three years on each of the eleven counts to be served concurrently.

List and Support Five Indicators or Elements of Fraud

1. _____

2. _____

3. _____

4. _____

5. _____

CASE 4 - OTHER DIRECT COSTS

THE SOS COMPANY HAD A COST REIMBURSABLE CONTRACT WITH THE AGENCY TO EXAMINE THE PERFORMANCE OF VARIOUS PROJECTS FUELED WITH RENEWABLE ENERGY RESOURCES. THE \$800,000 PER YEAR CONTRACT WAS ISSUED 3 YEARS AGO. THE SCOPE OF THIS AUDIT WAS LIMITED TO AN EXAMINATION OF OTHER DIRECT COSTS INCURRED. THE OBJECTIVES OF THE AUDIT WERE TO DETERMINE THAT COSTS CHARGED TO THE CONTRACT WERE:

1. ALLOWABLE UNDER APPLICABLE LAWS AND REGULATIONS, CONTRACT TERMS, COST PRINCIPLES CONTAINED IN THE FAR, AND GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES.
2. REASONABLE IN AMOUNT.
3. PROPERLY ALLOCABLE TO THE CONTRACT.

THE AUDITOR FOUND THAT COMPANY REVENUES FOR SIMILAR TYPE SERVICES WERE OBTAINED FROM COMMERCIAL (35%) AND FEDERAL GOVERNMENT (65%) SOURCES. THE TWO OTHER GOVERNMENT CONTRACTS WERE FOR LESSOR AMOUNTS THAN HIS AGENCY'S CONTRACT. THE COMMERCIAL CONTRACTS WERE GENERALLY FIXED PRICE AGREEMENTS.

THE SOS COMPANY WAS RELUCTANT TO LET THE FEDERAL AUDITORS EXAMINE ITS RECORDS. THE AUDIT WAS INITIALLY SCHEDULED TO START 6 MONTHS EARLIER BUT COMPANY OFFICIAL BEGGED FOR DELAYS GIVING AS EXCUSES THAT KEY INDIVIDUALS WERE SICK, SPECIFIC DOCUMENTS HAD BEEN MISPLACED, AND THAT URGENT MATTERS RESTRICTED THE AVAILABLE TIME THAT KEY OFFICIALS WOULD HAVE TO SPEND WITH THE AUDITORS.

ONCE THE AUDIT BEGAN, THE AUDITORS FOUND THAT CERTAIN SUPPORTING RECORDS COULD NOT BE PRODUCED TO ACCOUNT FOR EXPENSES CHARGED AGAINST THE AGENCY'S CONTRACT AS OTHER DIRECT COSTS. WHEN PRESSED TO SUPPORT ITS CHARGES, THE AGENCY COULD PRODUCE ONLY COPIES OF ORIGINAL DOCUMENTS. FURTHERMORE, THE PROCEDURES EMPLOYED BY THE COMPANY TO ALLOCATE COSTS TO ITS FEDERAL CONTRACTS WERE NOT CONSISTENT WITH ITS BUSINESS PRACTICES ON IT COMMERCIAL ACCOUNTS.

IN THIS AUDIT, THE AUDITOR FOUND THAT THE COMPANY HAD CHARGED COSTS ON ITS GOVERNMENT CONTRACTS THAT DID NOT APPEAR TO BE ASSESSED EQUALLY ON ITS COMMERCIAL CONTRACTS. AVAILABLE RECORDS DID NOT SUPPORT THE ALLOCATIONS OF COSTS THAT WERE MADE. WHEN QUESTIONED ABOUT THE DISCREPANCIES, THE ACCOUNTING SUPERVISOR INDICATED THAT THE CHARGES WERE BASES ON PROVISIONAL ASSESSMENTS THAT WOULD EVENTUALLY BE RECONCILED AND SETTLED AT THE END OF THE CONTRACT.

- TASKS:
- 1 Identify the characteristics of illegal acts that exist.
 2. For one of the above characteristics, design appropriate audit steps that would help determine intent.
 3. Identify at least one fraud statute that may have been violated and the corresponding elements of proof required.

CASE 5 - TRAVEL

THE REGION INITIATED AN AUDIT OF TRAVEL ADVANCES AND REIMBURSEMENTS. THE AUDIT WAS IDENTIFIED AS A PERFORMANCE AUDIT WHERE THE ECONOMY AND EFFICIENCY OF THE ACTIVITY WERE TO BE EXAMINED. AT THE ENTRANCE CONFERENCE THE AUDITORS IDENTIFIED THEIR AUDIT OBJECTIVES, SCOPE AND METHODOLOGY. THE AUDIT OBJECTIVES WERE TO DETERMINE THAT:

1. TRAVEL REIMBURSEMENTS AND ADVANCES WERE PROVIDED ONLY FOR PROPERLY AUTHORIZED TRAVEL.
2. AMOUNTS PAID WERE IN ACCORDANCE WITH APPLICABLE GOVERNMENT TRAVEL REGULATIONS.
3. REIMBURSEMENTS WERE TIMELY, PROPERLY APPROVED, AND PROPERLY RECORDED TO THE APPROPRIATE ACCOUNT.
4. ADVANCES WERE LIQUIDATED WITHIN REASONABLE TIME PERIODS.

THE AUDIT BEGAN WITH A SURVEY OF OFFICE PROCEDURES. THE AUDITORS FOUND THAT TO EXPEDITE TRAVEL ARRANGEMENTS THE OFFICE DIRECTOR HAD HIS SECRETARY PREPARE ALL TRAVEL ORDERS BASED ON ITINERARIES PROPOSED BY THE STAFF MEMBERS. LIKEWISE, THE SECRETARY HAD THE TRAVELER SKETCH OUT HIS EXPENSES FOLLOWING A TRIP AND SIGN A BLANK VOUCHER THAT WAS THEN TYPED BY THE SECRETARY, APPROVED BY THE OFFICE DIRECTOR, AND SUBMITTED FOR PAYMENT. A COPY OF THE TYPED VOUCHER WAS RETURNED TO THE TRAVELER. THE SECRETARY PICKED UP ALL TRAVEL ADVANCES AND EXPENSE PAYMENTS THEN REIMBURSED THE TRAVELER.

WRITTEN OPERATING PROCEDURES DID NOT REFLECT THE PRACTICES IN PLACE. BOTH THE OFFICE DIRECTOR AND HIS SECRETARY WERE IRRITATED BY THE QUESTIONS ASKED THE AUDITORS REGARDING CURRENT OPERATING PROCEDURES. WHEN THE AUDITORS BEGAN REVIEWING A SAMPLE OF OUTSTANDING TRAVEL ADVANCES, TRAVEL VOUCHERS, AND TRAVEL AUTHORIZATIONS THE OFFICE DIRECTOR INSISTED ON KNOWING WHICH ITEMS WERE BEING TESTED.

AUDIT TESTS FOUND THAT TRAVEL ADVANCES HAD NOT BEEN SETTLED MONTHS AFTER THE TRAVEL WAS TO HAVE BEEN COMPLETED, THAT APPROVED TRAVEL VOUCHERS OCCASIONALLY REFLECTED DEPARTURES FROM TRAVEL ITINERARIES ORIGINALLY PROPOSED, AND THAT ONE INDIVIDUAL WHO FILED SEVERAL TRAVEL VOUCHERS DURING A SIX MONTH PERIOD COULD NOT BE VERIFIED AS BEING ON THE PAYROLL.

- TASKS:
1. Identify the characteristics of illegal acts that exist.
 2. For one of the above characteristics, design appropriate audit steps that would help determine intent.
 3. Identify at least one fraud statute that may have been violated and the corresponding elements of proof required.

VI-8-7

SECTION 7
CIVIL AND
ADMINISTRATIVE ACTIONS

SECTION VII. Civil and Administrative Actions

Objectives

This section briefly discusses the civil and administrative actions available to EPA to obtain recoveries of fraudulently obtained funds. These civil and administrative actions are important in deterring and preventing fraud and should be pursued even if criminal actions are not likely. This section specifically addresses the new Program Civil Fraud Remedies Act and the EPA OIG Suspension and Debarment Program.

A. PROGRAM FRAUD CIVIL REMEDIES
ACT OF 1986

"Mini-False Claims Act" designed to authorize agencies to recover, administratively, double damages and civil penalties on fraud cases below \$150,000 - if the DOJ declines prosecution.

B. CAUSES FOR SUSPENSION OR DEBARMENT

1. Civil and criminal judgments
2. Criminal violation without prosecution
3. Nonperformance on a contract
4. Noncompliance with regulations, laws or standards
5. Other practices showing lack of business integrity
6. Debarment by another Federal agency

Exhibit

Fraud Detection in EPA Projects

CIVIL AND ADMINISTRATIVE ACTION

Suspension and Debarment Program

EPA's policy is to do business only with contractors, grantees, and persons who are responsible, honest, and who comply with applicable rules and regulations. EPA enforces this policy by suspending or debarring any organization or person for acting improperly, having a history of substandard work, or willfully failing to perform on EPA or other Federally funded activities. Suspensions and debarments deny participation in Agency programs and activities to those who represent a risk of abuse to the Government.

I. PURPOSE

- A. Protection of the Government-contractor responsibility
- B. Cut down on exposure to corrupt corporations
- C. Only legal means to stop doing business with contractor

II. GROUNDS FOR DEBARMENT - The Federal Acquisition Regulations (FAR) provide the grounds for debarment.

- A. FAR 9.406-2 Causes for Debarment. The debarring official may debar a contractor for any of the causes listed in 1 through 3 following:

1. Conviction of or civil judgment for --
 - a. commission of fraud or a criminal offense in connection with obtaining, attempting to obtain, or performing a public contract or subcontract;
 - b. violation of Federal or State antitrust statutes relating to the submission of bids or proposals;
 - c. commission of embezzlement, theft, forgery, bribery, falsification or destruction of records, making false statements, or receiving stolen property; or
 - d. commission of any other offense indicating a lack of business integrity or business honesty which seriously and directly affects the present responsibility of a Government contractor or subcontractor.
2. Violation of the terms of a Government contract or subcontract so serious as to justify debarment, such as --
 - a. willful failure to perform in accordance with the terms of one or more contracts; or
 - b. a history of failure to perform, or of unsatisfactory performance of, one or more contracts.
3. Any other cause of so serious or compelling a nature that it affects the present responsibility of a Government contractor or subcontractor.

Exhibit

Fraud Detection in EPA Projects

CIVIL AND ADMINISTRATIVE ACTION

Suspension and Debarment Program (continued)

- B. In addition to the firms and individuals debarred for the above causes the following firms and individuals are identified as "ineligible."
1. Contractors excluded pursuant to the Davis-Bacon Act, Walsh-Healy Act, Service Contract Act, or for violations of the Copeland Anti-Kickback Act, Contract Work Hours and Safety Act.
 2. Buy-American Act, 41 U.S.C. 10.
 3. Environmental Statutes
 - a. Federal Water Pollution Control Act 33 U.S.C. 125; or
 - b. Clean Air Act, 42 U.S.C. 1857.
 4. Equal Employment Opportunity, Executive Order 11246
 - a. Violations of the Equal Employment Order 11246;
 - b. Failure to submit acceptable affirmative action plans; or
 - c. Failure to meet minority utilization goals
- C. Grounds for Suspension - FAR 9.407-2 are similar but stated more simply. Indictment for any of the enumerated crimes is stated to be adequate evidence for suspension.

III. DURATION OF DEBARMENT AND SUSPENSION

A. Duration of Debarment

1. Generally does not exceed 3 years (credit for "time served")
2. ~~Since~~ keyed to "responsibility" courts may permit showing of ~~present~~ responsibility or corporate reforms

B. Duration of Suspension

1. Normally not exceeding 12 months unless legal proceedings initiated, but if they have been, then until completed.
2. Assistant Attorney General may request an additional 6 months.

Exhibit

Fraud Detection in EPA Projects

CIVIL AND ADMINISTRATIVE ACTION

Suspension and Debarment Program (continued)

IV. GOVERNMENT-WIDE SCOPE OF DEBARMENT

- A. All executive branch agencies.
- B. Covers contracts and subcontracts for which Government approval is required.
- C. Does not cover "contractors under grants" but agencies in which most of funds are given to others to contract with are developing "linkages" between debarments of contractors and contractors under grants (HUD, DOT, EPA)

SECTION 8
SPECIFIC TYPES OF FRAUD
FOUND IN EPA WORK

SECTION VIII. Specific Types of Fraud Found in EPA Projects and Their Indicators

Objectives

This section synthesizes the information from the previous sections on general fraud schemes and their indicators and applies it to specific types of fraud found in EPA. Experience has proven that EPA contracts and projects are particularly vulnerable to certain types of fraud. This section outlines several of those fraud schemes and the indicators that can be used to test for and identify the possibility of fraud. It should be emphasized that any questioned costs where funds were spent: outside the scope of the grant agreement, for items clearly ineligible for grant funding, for items that have been previously disallowed, in excess of industry standards, for unnecessary items, where supporting records of transactions are consistently unavailable or incomplete, with unapproved or frequent use of modifications or change orders, and, by splitting contracts to avoid the competitive bidding process represents possible fraud instead of merely mistake if there appears to be any indication of intent.

A. FRAUD FOUND IN EPA-FUNDED WORK

1. Labor fraud
2. Product substitution
3. Antitrust violations
4. Defective pricing
5. Cost mischarging
6. Progress payment fraud
7. Contract modification fraud
8. Corruption

B. DEFECTIVE LABOR

1. Falsely allocating costs to or from other contracts
2. Padding the payroll with
 - a. Fictitious employees
 - b. Separated employees
 - c. Excessive, false, or undocumented overtime

C. LABOR FRAUD: BASIC CONCERNS

1. Did the employees charge the project on which they actually worked?
2. Were the proper rates and hours charged?
3. Were the specifications for the amount and type of labor accurate (or padded)?
4. Were the employees claimed to have been paid actually employed?
5. Were the employees paid the amount claimed?

D. FRAUD FOUND IN EPA-FUNDED WORK

1. Excessive or unusual labor charges by personnel who are normally part of overhead
2. Abrupt changes in labor charge levels for no apparent reason
3. Labor time and charges inconsistent with project progress
4. Inability of contractor to immediately supply time cards upon demand
5. Time cards show consistent erasures or alterations
6. Time cards completed by supervisor
7. Low-level work charged by high-level wage earners

E. LABOR FRAUD: SUGGESTED AUDIT STEPS

1. Verify standard costs
2. Check time records
3. Compare payments to claims
4. Interview workers about how work is being charged
5. Perform head count
6. Analyze changes or adjustments
7. Do trend analysis

F. DEFECTIVE PRICING

1. False vendor costs for goods
2. False billings
3. Exchanged checks and fictitious corporations
4. Overpayment and refund
5. Overcharge and kickback by vendor

G. DEFECTIVE PRICING: INDICATORS

1. ~~Persistent~~ or repeated defective pricing
2. ~~Failing~~ to update data when prices decreased
3. Use of unqualified personnel to develop data
4. Falsification or alteration of supporting data
5. Denial of existence of historical data that was later found
6. Failure to make complete disclosure of data
7. Protracted delay in release of data to Government to preclude possible price decrease
8. Employment of persons who previously defrauded the Government
9. Identical high salary history data on employees or consultants

H. ANTITRUST ACTIVITIES

Agreements to:

1. Adhere to published price list
2. Raise price by stated increment
3. Establish, use, or eliminate discounts
4. ~~Not~~ advertise prices
5. ~~Use~~ stated price differentials based on quantity, type, or size of product

Exhibit

Practices or Events that may Evidence Collusive Bidding or Price Fixing are:

1. Bidders who are qualified and capable of performing but who fail to bid, with no apparent reason. A situation where fewer competitors than normal submit bids typifies this situation. (This could indicate a deliberate scheme to withhold bids.)
2. Certain contractors always bid against each other or conversely certain contractors do not bid against one another.
3. The successful bidder repeatedly subcontracts work to companies that submitted higher bids or to companies that picked up bid packages and could have bid as prime contractors but did not.
4. There is an apparent pattern of low bids regularly recurring, such as corporation "x" always being the low bidder in a certain geographical area or in a fixed rotation with other bidders.
5. Failure of original bidders to rebid, or an identical ranking of the same bidders upon rebidding, when original bids were rejected as being too far over the Government estimate.
6. A certain company appears to be bidding substantially higher on some bids than on other bids with no logical cost differences to account for the increase, i.e., a local company is bidding higher prices for an item to be delivered locally than for delivery to points farther away.
7. Bidders that ship their product a short distance bid more than those who must incur greater expense by shipping their product long distances.
8. Identical bid amounts on a contract line item by two or more contractors. Some instances of identical line item bids are explainable, as suppliers often quote the same prices to several bidders. But a large number of identical bids on any service-related item should be viewed critically.
9. Bidders frequently change prices at about the same time and to the same extent.

Exhibit

Practices or Events that may Evidence Collusive Bidding or Price Fixing are: (continued)

10. Joint ~~venture~~ bids where either contractor could have bid individually as a ~~prime~~. (Both had technical capability and production capacity.)
11. Any incidents suggesting direct collusion among competitors, such as the appearance of identical calculation or spelling errors in two or more competitive bids or the submission by one firm of bids for other firms.
12. Competitors regularly socialize or appear to hold meetings, or otherwise get together in the vicinity of procurement offices shortly before bid filing deadlines.
13. Assertions by employees, former employees, or competitors that an agreement to fix bids and prices or otherwise restrain trade exists.
14. Bid prices appear to drop whenever a new or infrequent bidder submits a bid.
15. Competitors exchange any form of price information among themselves. This may result from the existence of an "industry price list" or "price agreement" to which contractors refer in formulating their bids or it may take other subtler forms such as discussions of the "right price."
16. Any reference by bidders to "association price schedules," "industry price schedules," "industry suggested prices," "industry-wide prices," or "market-wide prices."
17. A bidder's justification for a bid price or terms offered because they follow the industry or industry leader's pricing or terms. This may include a reference to following a named competitor's pricing or terms.
18. Any statements by a representative of a contractor that his company "does not sell in a particular area" or that "only a particular firm sells in that area."
19. Statements by a bidder that it is not their turn to receive a job or conversely that it is another bidder's turn.
20. Different groups of contractors appear to specialize in Federal, State, or local jobs exclusively.
21. There is an inexplicably large dollar margin between the winning bid and all other bids.

I. EXAMPLES OF COLLUSIVE BIDDING

1. Bid suppression or limiting
2. Complementary bidding
3. bid rotation
4. Market division

J. COST MISCHARGING

Contractor charges the Government for costs which:

1. are not allowable
2. are not reasonable
3. cannot be directly or indirectly allocated to the contract

K. COST MISCHARGING - UNALLOWABLE COSTS

1. Advertising costs (with exceptions)
2. Bid/proposal costs exceeding a set limit
3. Stock options or other deferred compensation
4. Contingencies
5. Entertainment costs
6. Contributions or donations
7. Interest
8. Independent R/D costs exceeding a set limit
9. Cost of idle facilities (with exceptions)
10. Losses on other contracts
11. Long-term leases exceeding ownership costs
12. Legal costs related to a contractor's unsuccessful defense against charges of contract fraud

L. DEFECTIVE PRODUCTS

1. ~~Substitution~~ of inferior products
for those specified
2. False test results
3. False certification of
 - a. Tests
 - b. Compliance with specifications

M. PRODUCT SUBSTITUTION

Attempts by contractors to deliver goods to the Government which do not conform to contract requirements:

1. Without informing the Government of the deficiency
2. While seeking payment based on delivery of products or services alleged to conform

N. PRODUCT SUBSTITUTION: INDICATORS

1. Delivery of look-alike goods made from nonspecification materials
2. Materials not tested as required by contract
3. Foreign-made products when domestic was required
4. ~~Stick~~-on "MADE IN USA" emblems
5. ~~Boxes~~ with part of label always obliterated
6. Goods always defaced in the same area
7. Goods without I.D. or specification plate
8. Goods that seem used when new was required
9. Differences between goods that should be same
10. Missing source origin documentation

O. PROGRESS PAYMENT FRAUD

Contractor requests payment
based on:

1. Falsified direct labor charges
2. Material costs for items not
actually purchased
3. Falsified certification of a stage
of completion or work accomplished

P. PROGRESS PAYMENT FRAUD: INDICATORS

1. Firms with cash flow problems
2. Payments that do not coincide with
contractor's plan or capacity
3. Claims for materials for which
the contractor has not paid

O. PROCESSING PAYMENTS

1. Review reports on progress of work
2. Tie payments to definite tasks or
milestones
3. Compare invoice data to work status
reports
4. Determine if payments were suspended
or work was stopped
5. Track total payments to the contract
terms
6. Determine if work was completed before
contract award or notice to proceed
7. Resolve monitoring or audit findings
before making final payment
8. Segregate duties

R. CONTRACT MODIFICATIONS

1. Adequate documentation
2. Justification of
 - a. Need
 - b. Noncompetitive procurement
 - c. Benefit to Government
3. Cost or price analysis
4. Proper advance approval

S. CORRUPTION

1. Conspiracy
2. Conflict of interest
3. Embezzlement
4. Conversion

SURCONTRACTOR KICKBACKS

1. Introduction

Recent Senate hearings focused on abuses in subcontract management, specifically subcontractor kickbacks. It was estimated in testimony at those hearings that from 10 to 50 percent of all subcontractors are involved in some type of payment scheme. The abuses could range from paying for a buyer's lunch to payoffs in the thousands. With subcontracts for DOD procurements running \$47 billion in FY 1984, subcontract kickbacks and substantial sums to the price of everything the Government buys.

Subcontractor kickbacks are apparently a widespread, longstanding, and entrenched practice. Buyers can easily disguise kickback situations by producing documentation to demonstrate and justify the award of a purchase order. Kickbacks occur most frequently in subcontracts under \$100,000. Purchase orders under \$10,000 are extremely vulnerable because of lack of scrutiny.

Unfortunately, standard audit approaches and contractor purchasing system reviews are not likely to uncover subcontract kickbacks. The documentation involved appears legitimate and the paid invoices usually do not reflect the kickbacks. Instead, internal control reviews should be used to assess the contractor's vulnerability in these areas. The failure of the contractor to monitor and control its employees' activities properly contributes to the problem through lack of attention and inaction.

2. Background

Kickback schemes are arrangements between subcontractors and the prime contractor's buyers, high level officials or even owners. The subcontractor agrees to pay a percentage of all subcontracts awarded to the subcontractor by the prime. One kickback scheme is called a "bump" agreement. In these cases, the prime's agent tells the vendor how much he or she can raise the bid and still be low bidder. Another system is courtesy bidding. Courtesy bidding revolves around various vendors taking turns being the low bidder. When a company is not designated the low bidder, it submits an artificially high bid to protect the designated vendor's bid. In other instances, the contractor's agent may disclose the legitimate bids to the designated vendor so he or she can underbid the competition. The contractor's representative may also disqualify legitimate low bids on the basis of technical or financial capability and award the subcontract to the preferred vendor.

Kickbacks can be in various forms. Cash, illegal drugs, cars, appliances, tools, airline tickets, package vacations have all been used as payoffs. In some extreme cases, the recipient of the kickback has sent bills to the subcontractor for purchased items or used the subcontractor's credit cards for purchases.

The subcontractor could also pay kickbacks to a nonexistent company or one that is created solely to facilitate payments from the subcontractor to the recipient of the kickback. These payments may be for consulting services or services and materials which appear related to the contract, however, when compared to overall costs and other actual charges, they show up as unusual.

Exhibit

3. Fraud Indicators

- a. Poor contractor internal controls over key functional areas, such as purchasing, receiving, and storing.
- b. Lack of subdivision of duties between purchasing and receiving.
- c. Lack of rotation or subdivision of duties in the purchasing department. Buyers should be rotated to prevent familiarity with specific vendors.
- d. None or few contractor policies on ethical business practices.
- e. Poor enforcement of existing contractor policies on conflicts of interest or acceptance of gratuities.
- f. Purchasing employees maintaining a standard of living obviously exceeding their income.
- g. Instances of buyers or other employees circumventing established contractor procedures for competition of subcontracts.
- h. Poor or no established procedures for the competition of subcontracts.
- i. Poor documentation of sole source award of subcontract.
- j. Poor documentation of award of competitive subcontract.
- k. Lack of competitive awards.
- l. Nonaward of subcontract to lowest bidder.
- m. A one-time payment to a company for services or materials usually bought from another vendor(s). The kickback recipient could be using the company to obtain his payoff.

4. General Comments. Detection of subcontract kickbacks is difficult. Standard audit procedures normally will not uncover such schemes. The auditor must be alert to obvious weaknesses in the contractor's internal controls which make taking payoffs easy instead of difficult. Audits of the contractor's material purchasing, receiving, and storing systems will point out other weaknesses or noncompliance with existing contractor policies and procedures. Physical verification of the existence of inventories or materials charged direct to a job will also show how vulnerable the contractor's system is to fraud. A subcontract management review may be the best way to evaluate the contractor's policies and procedures for awarding subcontracts. This could assure that the contractor is following the proper procedures.

ACCOUNTING MISCHARGES

1. Scenario. A sampling of time cards revealed that time card alterations were pervasive. Time card changes for engineering and production personnel were either made before or after the time cards were keypunched for payroll preparation and labor distribution. In some instances, alterations were made by erasures or typing correction fluid; and changes were made by lining out the original job order/project number and substituting another number. Analysis of job cost records showed that labor costs were switched: (1) from CPFF overrun contracts to those with remaining funds, and (2) from Government FFP/commercial contracts to CPFF contracts with available funds.

Indicator. In the course of auditing labor charges to Government contracts, many instances were found where time cards were altered without evidence of approval by the employee or supervisor. Also, review of established internal controls disclosed that the contractor did not have a written policy on changes or corrections to time cards.

Monetary Impact. Over 5,000 hours were transferred equating to a benefit of \$110,000 to the contractor.

- b. Scenario. The time sheets and accounting records did not show charges to one or more of the jobs on which employees had identified during the floor check. The mischarging involved charges to two overhead accounts instead of fixed-price commercial and Government T&M contracts.

Indicator. While conducting a review of timekeeping procedures which included observations of work areas, the auditor discovered that employees were being directed by management to charge overhead accounts for work done on fixed-price commercial and Government T&M contracts.

Monetary Impact. Estimated overcharges to Government cost-type contracts totalled \$500,000.

- c. Scenario. Many original time report entries had been obliterated by applying typist snopack (white ink) on both the face and reverse of the time report so that another entry could be substituted. The employee semi-monthly time reports were summarized on a Monthly Labor Distribution Summary (MLDS) to support the direct labor billed to the Government. The auditor found that the MLDS was also altered to match the entries on the employee semi-monthly time reports. The effect of the alterations shifted labor costs from commercial contracts to Government contracts.

Indicator. During a review of direct labor costs charged to Government cost reimbursement-type contracts, the auditor noted considerable alterations of employee's semi-monthly time reports.

Monetary Impact. The magnitude of the mischarged labor cost and applicable indirect expenses amounted to \$475,000.

Scenarios of Potential Fraud -- Making the Referral

Scenario 1: While reviewing claimed equipment rental costs, you noted that the supporting vendor invoice's serial numbr was neither compatible in tyographical size nor in numerical sequence with other vendor invoices submitted during the period. It was also noted that the typed statement on the invoice "Paid in Full (Cash), 30 September 1980" was in larger typeface than preceding paid invoices from the same vendor. A review of the general ledger receivable account at the vendor location revealed no record of this transaction. You ascertained that the contractor used a "dummy" vendor invoice to support the estimate.

Scenario 2: During discussions with a vendor company official, you learned the quotes had not been furnished to the contractor. The contractor had a supply of signed blank supplier's quotation forms which he used to support the proposed inflated prices. The supplier said he had provided the contractor with the blank forms with the proviso that, after the contractor completed the forms, they would be returned to him for validation.

Scenario 3: You conducted a labor floor check with the assistance of a Government technical representative and observed that several engineers were charging an overhead account for work effort which should have classified as either Independent Research & Development (IR&D) or Bid and Proposal (B&P). Also, examination of the engineers' notebooks confirmed that the effort was IR&D/B&P and not other indirect effort. (The company required engineers to maintain notebooks to record notes, idea sketches, computations, illustrations, etc.) Had such work been charged to the proper IR&D or B&P project, the contractor would not have received reimbursement from the Government since the authorized ceiling amounts had been exceeded.

Scenario 4: Examination of the job site equipment listing revealed that two material hoists were never assigned to the job site, although \$15,000 was claimed for rental. Further analysis of the equipment list equipment transfer dates showed that other equipment costs were overstated by \$28,000. In addition, the contractor included \$27,000 in the claim for "Operating Engineers" to operate the material hoists. The contractor proposed \$65,000 for job supervision and engineering--ostensibly representing the salaries of 10 employees for the entire 125-day delay period. A comparative examination of the employee listing with payroll records disclosed that some individuals were either hired by the company during or after the claimed delay period or were transferred from other contracts to the subject contract during the delay period. Excessive costs of \$25,000 were questioned.

Scenario 5: While reviewing equipment rental costs of \$62,000 relating to a 200-ton crane, you requested as documentation, a lease agreement and respective invoices. The lease agreement and the initial invoice showed that the crane was delivered to the work site during June 1986, with the first payment covering the period 27 June 1986 to 26 July 1986. The costs claimed for the crane were incurred after the purported delay period (15 January-30 June 1986); therefore, the contractor had no basis for including the rental costs in its claim. The contractor could not offer any basis or rationale for its inclusion.

Scenario 6: The contractor included \$70,000 for materials in its PPR supposedly invoiced by the vendor company. Close examination of the invoice indicated it was fictitiously prepared using another company's invoice. Information on the earlier invoice was eliminated with correction fluid, except for the "company name" and "sold to" information. False information pertaining to a purchase was entered on the forged invoice, e.g., description of the material quantities and monetary extensions.

Scenario 7: A prime contractor submits a proposal to EPA which includes a subcontract for a major piece of equipment using the subcontractor's budgetary quota to support the price of the piece of equipment. Within a few days of sending the budgetary quote, the subcontractor provides firm quotes in response to a request from the prime contractor.

You begin a review on the contract and find the price of the equipment is different than the one proposed. The review also shows that, at the time of price agreement, the contractor had both budgetary quotes and firm quotes. The firm quotes were lower than the proposed prices, but this information was not disclosed to the Government. The date on the firm quotes were within a few days of the budgetary quotes and, in some instances, were received on the same day. None of the firm quotes were ever disclosed.

Scenario 8: A contractor submits a proposal for a follow-on contract to paint a building that is part of a wastewater treatment plant under construction and says that he will use the prior contract as a basis of supporting the proposed labor costs for the follow-on contract.

The contractor uses learning curve techniques to arrive at the cost estimation for the labor hours. Everything seems to be in order and properly disclosed. The contractor prepares the proposal by using the painters' labor hours times the labor rate. The contract is negotiated based on the cost and pricing data. What the contractor fails to disclose is that on the previous contract, painters, painter helpers, and laborers were used to do the job.

During the contract performance, the company sends status reports listing the hours incurred on the previous contract and the painter labor rate. As part of your review, you ask for the labor records. The contractor tells you that the timecards and other labor records have been destroyed.

An additional review of the payroll records shows that the workforce was evenly split between painters, painter helpers, and laborers. You also find that other painting contracts had the same labor mix.

EXAMPLES OF DEFECTIVE PRICING

EPA Pays Excessive Amounts for Emergency Cleanups of Hazardous Wastes

Problem

The urgent need for emergency hazardous waste cleanups led EPA to award multimillion dollar contracts for Emergency Response Cleanup Services (ERCS) with limited competition and without assurances that the negotiated rates were reasonable. As a result, EPA is paying excessive amounts for the emergency cleanups.

Background

Following Superfund authorization in 1980, EPA initially used Notice to Proceed contracts authorizing a specific firm to perform emergency cleanups. However, the rates and other terms of the contract were frequently not finalized until the cleanup was well underway or completed. The ERCS contracts were meant to provide a better approach for obtaining cleanup services by dividing the country into four geographical zones with an ERCS contractor responsible for emergency cleanups in each zone. The zone contracts specified 126 equipment items and labor categories for which fixed rates were negotiated. Other services were reimbursable under a cost-plus-fixed-fee arrangement. The potential value of the contracts over a 3-year period was \$186 million. Actual cleanup work for specific sites was authorized through individual delivery orders.

We Found That

On the twelve individual delivery orders audited, ERCS contractors were paid an average markup of 40 percent over their labor costs and labor billed to EPA under the fixed rates ranged from 14 percent to 103 percent over the contractors' actual costs. Contractors billed labor at holiday and overtime premium rates even though they frequently did not pay these

higher rates to their employees. Contractor and subcontractor employees who are working away from home are allowed per diem expenses to cover food and lodging. However, we found that per diem expenses were invoiced to EPA with an average 10 percent markup or \$25,452 more than actual expenses.

Below are some examples of the overtime rates charged but not paid.

| Category | Estimated Costs | Overtime Contract Rates | Markup |
|-------------------|-----------------|-------------------------|--------|
| Chemical Engineer | \$41.54 | \$58.80 | 42% |
| Clerk | \$14.14 | \$21.50 | 52% |
| Response Manager | \$35.58 | \$64.10 | 80% |

Equipment items were billed to EPA with markups over cost ranging from averages of 143 percent on monthly rates to 321 percent on hourly rates. Markups on individual items varied from 37 percent under costs on a particular pickup truck to an instance when the contractor billed EPA 160 times

the cost of a trash pump at the fixed rate.

Below is an example of a commonly used item which was excessively marked up: personal protection equipment (level B), including chemical resistant, and disposable clothing with hard hat, 2-way radio, and breathing apparatus.

| Delivery Order | Amount Billed | Estimated Cost | Markup |
|----------------|---------------|----------------|--------|
| 1 | \$ 100 | \$ 12 | 864% |
| 2 | 26,087 | 4,925 | 430% |
| 3 | 8,675 | 4,208 | 106% |
| Total | \$34,862 | \$9,145 | 281% |

The ERCS contracts provided for subcontracting transportation and disposal of hazardous wastes from cleanup sites by the four zone contractors. We found that of \$1.2 million in transportation and disposal services we reviewed, \$240,500 of cost may have been incurred unnecessarily by the Agency as a result of poor procurement practices of the zone

contractors. We found instances where the lowest bidder was not selected and where EPA paid rates that were higher than rates charged "preferred customers."

Below are examples of some additional commonly rented items which were excessively marked up. Markups vary based upon the rental period.

| Item | Range of Estimated Costs | range of Billed Rates | Range of Markups |
|-------------------------|--------------------------|-----------------------|------------------|
| Stakebed Truck (2-ton) | \$2.95 - \$510.94 | \$ 16 - \$1,365 | 442% - 167% |
| Hand Tools | \$ 16 - \$ 3.46 | \$ 11 - \$ 126 | 6,775% - 3,542% |
| Decontamination Trailer | \$4.64 - \$100.46 | \$300 - \$3,000 | 6,473% - 2,886% |
| Trash Pump (2-inch) | \$ 10 - \$ 17.32 | \$ 16 - \$ 945 | 15,900% - 5,356% |

New York Firm Indicted for \$6 Million Fraud

Michael Gelb and Thomas Gelb, president, vice president, and sole owners of Federal Chandros, Inc. (FCI), were indicted on February 11, 1987 for fraud on the EPA-funded Owls Head Wastewater Treatment Plant project in Brooklyn, New York, on which FCI was the prime electrical contractor. According to the indictment, the Gelbs were involved in a continuing scheme between 1980 and 1986 to defraud the city of New York by submitting false or altered claims for payment.

The indictment charged that FCI obtained a total of \$6 million in illegal payments and credits on electrical contracts from various city agencies. Besides the EPA-funded Owls Head project, the Gelbs were charged with defrauding the city on electrical projects for the New York City Transit Authority, the New York County Supreme Court, the New York City Police Department, and the Metropolitan Museum of Art.

The Gelbs allegedly photocopied invoices paid by FCI, altered the dollar amounts and delivery information, rephotocopied the invoices to disguise the alterations and submitted them for reimbursement. In addition, they allegedly submitted totally fictitious claims. Seized records of FCI included numerous blank invoices and stationery of other vendors.

The indictment charged the Gelbs with fraud in connection with the employment of minority business enterprises (MBE) to meet Federal and city contractual requirements on the Owls Head project and other contracts. Allegedly, the Gelbs fraudulently received credit for \$5.3 million under the MBE program.

This indictment resulted from the joint investigative efforts of the EPA Office of Inspector General, the OIG for the New York City Department of Environmental Protection, the Federal Bureau of Investigation, and the New York City Department of Investigations.

Pipe Supplier Prosecuted in Conspiracy Scheme

The owner and operating manager of a New York City pipe company pled guilty of conspiring to transport stolen pipes that were to be used on EPA-funded wastewater treatment projects in New York City and to defraud the Internal Revenue Service.

Both defendants admitted paying New York City employees responsible for maintaining the city's pipe yards about \$250,000 in bribes for access to the material in those yards. The defendants subsequently stole and resold pipes to the contractors doing business with the city on EPA-funded and other projects.

They created and supplied city contractors with approximately \$3 million worth of fictitious invoices for pipes used on city projects and paying the contractors substantial kickbacks laundered through their own shell and other corporations.

Inadequate Documentation Creates Disallowances for Charleston, West Virginia, Grantee

Despite receiving a \$16.8 million sewage treatment grant, the Elk Pinch Public Service District's recordkeeping and accounting practices did not comply with EPA and Federal regulations. Insufficient support, duplicate entries, incorrect participation formulas, and the claiming of unrelated expenses led to \$926,870 in questioned costs. We also set aside \$1.7 million, primarily associated with architectural and engineering fees, until further documentation could be provided.

The regional officials sustained \$1,275,221 of questioned and set-aside costs as a result of this audit.

Construction Delays, Poor Performance, and Unauthorized Change Orders Result in EPA's \$8.8 Million Disallowance of Grantee's Claim

The Middlesex County Utilities Authority in Sayreville, New Jersey, received three construction grants totalling \$80.3 million to improve and upgrade its sewage facilities. We questioned \$3.8 million due to construction delays, unauthorized change orders, the submission of insufficient cost documentation, and expense claims that were not within the scope of the grant.

Cost overruns, construction delays, uncertainty of performance, and change orders also accounted for about \$13 million in set-aside costs.

As a result of our recommendation that questionable costs be disallowed and that the eligibility of set-aside costs be evaluated, Region 2 sustained \$9,784,252 of the amount we questioned or set aside.

EXAMPLES OF ANTITRUST VIOLATIONS

Five Indictments Short Circuit Electrical Contractor's Bid Rigging Scheme

Dynalectric Company, McLean, Virginia, Fischbach and Moore Inc., Dallas, Texas, Paxson Electric Company, Jacksonville, Florida, G W Walther Ewatt, President of Dynalectric Company and Wesley C

Paxson, Sr., President of Paxson Electric Company were all indicted on September 19, 1986, for mail fraud and unreasonable restraint of trade and commerce in violation of the Sherman Act

The defendants were charged with conspiring to rig bids and fix prices on an electrical construction subcontract on the EPA-funded Snapfinger Creek Waste Water Treatment Project, DeKalb County, Georgia

The indictment charged the defendants with submitting collusive, noncompetitive bids so that Paxson Electric would be the low bidder and receive the electrical construction subcontract at the artificially high sum of \$4,915,000

In return for Fischbach and Moore's participation in the scheme, Paxson Electric allegedly agreed to forgive its preexisting debt of \$89,330.06. In return for Dynalectric's participation, Paxson Electric allegedly agreed to form a silent joint venture with Dynalectric pursuant to which Dynalectric would receive 50 percent of the profits earned from the performance of the subcontract and Paxson allegedly then paid Dynalectric \$680,000 as its share

These indictments resulted from the joint efforts of the Department of Justice Antitrust Division and the EPA Office of Inspector General

Electrical Contractors Rig Bids on Chattanooga Project, Fined \$900,000

Commonwealth Electric Company (CEC) and Fischbach and Moore, Inc. (FMI) were indicted on July 2, 1986, for unreasonable restraint of trade and commerce in violation of the Sherman Act. The indictment charged that CEC and FMI agreed that CEC would be the low bidder on the EPA-funded Moccasin Bend Wastewater Treatment Plant project in Chattanooga, Tennessee, and in return for FMI's participation in the conspiracy, CEC would make a payoff to FMI out of the profits CEC expected to earn from the contract or CEC would submit a collusive, artificially-high and rigged bid for FMI on a future project.

FMI was convicted and fined \$500,000 and CEC pled nolo contendere and was fined \$400,000 on September 29, 1986. EPA is seeking civil recoveries from FMI and CEC.

Conspiracy to Rig Election and Bids on Sewer Project

Brian Ingber, Supervisor of the Town of Fallsburg, New York, Howard Ingber, Wayne Pimos, Thomas Peck and Service Scaffold, Inc., Ingbers' family business were charged with conspiring to rig bids so that Service Scaffold, Inc., would have an advantage in winning an equipment supply contract on a \$24 million sewer project. The defendants allegedly manipulated the bidding process by conveying false information to competing bidders and concealing Brian Ingber's conflict of interest between his business and official position which included administering the sewer project.

The defendants were also charged with rigging Ingber's 1983 election as Supervisor by forging the signatures of registered voters on ballots and fraudulently obtaining signed absentee ballots.

Brian Ingber was convicted on January 16, 1986, of mail fraud for forging absentee ballots during his 1983 election. Brian Ingber was convicted again along with Wayne Pimos on June 18, 1986, for false statements and Brian Ingber and Service Scaffold, Inc., were found guilty of mail fraud.

Electrical Contractor Fined for Bid Rigging

An electrical contractor of Huntington West Virginia pled guilty on May 8, 1987, and was fined \$50 000 for

conspiring with others to rig bids on a \$2 million EPA-funded wastewater treatment project in Huntington, West Virginia

The contractor submitted an intentionally-high and noncompetitive bid on the project, artificially raising the price of a contract awarded to a co-conspirator. In return, the co-conspirator paid the contractor in the form of electrical construction materials

Contractor Convicted and Fined for Bid Rigging

The Modern Electric Company (MEC) of Statesville, North Carolina, and company officer E. Eugene Carson along with co-conspirators were convicted on January 9, 1985, of submitting collusive, non-competitive bids to Boone, North Carolina, so that one of the conspirators would be awarded a \$247,639 contract for electrical work on an EPA funded project. On February 25, 1985, MEC was fined \$10,000 and Carson was fined \$2,500 and sentenced to 120 days in a work release program to perform community service

Prosecution for Bid Rigging

The C. C. Moore Co., Inc., of Greenwood, South Carolina, pleaded guilty on July 25, 1985 to rigging bids in violation of Section 1 of the Sherman Antitrust Act (15 U.S.C. 1). In the April 4, 1985 indictment Moore Co. along with co-conspirators were charged with submitting collusive bids so that one of the conspirators would receive an award of \$1,689,820 to work on the EPA funded Winnsboro Sewage System Improvement Project. Moore Co. was fined \$50,000. Actions by Reporting Period, Fiscal 1985

- W. E. Boyette and his company, Watson Electric Company, Wilson, North Carolina, were each debarred for two years on April 15, 1985. On March 12, 1985, Boyette and Watson Electric pled guilty to charges that they and co-conspirators submitted collusive non-competitive bids on an electrical contract at a wastewater treatment facility in Orange County, South Carolina. The collusive bids were submitted so that an artificially high contract award of \$626,300 would be made for an EPA-funded project. Boyette was sentenced to 7½ months imprisonment. Watson Electric Company was fined \$248,000.

Dairies accused of bid-rigging on school milk

By CHARLES HOLMES

Palm Beach Post Staff Writer

TALLAHASSEE — Seven dairy companies and four distributors were accused of bullying Florida schoolchildren out of their milk money in a lawsuit filed Tuesday by the state.

Attorney General Bob Butterworth said the industry operated a sophisticated scheme to rig bids on

local school officials never sensed impropriety — 6A

contracts with 32 Florida school districts, including those of Palm Beach, Martin, St. Lucie and Okeechobee counties.

Butterworth said the civil lawsuit, filed in U.S. District Court in Miami, represents the largest antitrust action ever against the milk

industry.

The defendants include some of the biggest dairy-related corporations in the country. Butterworth said at a news conference "The ultimate effect of the conspiracy was to take cream from the pockets of Florida's schoolchildren. We find that to be shameful."

Dairy processors named in the lawsuit are Southeastern Corp. of Dal-

las, producer of Velda Farms milk; Borden Inc. of Columbus, Ohio; Flavorex Inc. of Louisville, Ky.; Dean Food Products Co. of Chicago; Pet Inc. of St. Louis; Kraft of Chicago, formerly the producer of Southeast milk in Florida; and Hart's Dairy of Fort Myers, now a subsidiary of Dean Foods.

State distributors named are Marshall Simmons Enterprises of

Mango, Pierson Distributors Inc. of Opa-locka, H & T Distributors Inc. of Homestead and Butler Foods of Naples.

Party individuals were named as co-defendants in the lawsuit. The companies are accused of carrying up the state and setting their prices before submitting bids to each school district, assuring that each company would get a

share of the profit from the sale of half-pint cartons of milk.

In what he called conservative estimates, Butterworth said the scheme had gone on for at least 18 years and cost schoolchildren about a penny more per half-pint of milk. On about 1 billion cartons sold in the past decade, the companies

Please see SAIT/6A

94 THE PALM BEACH POST WEDNESDAY, FEBRUARY 17, 1988

Schools say dairy firms 'never seemed unfair'



Attorney General Bob Butterworth says suit alleges overcharges of about 1 cent each for almost 1 billion half-pint milk cartons.

By MICHAEL ROMANO

Palm Beach Post Staff Writer

South Florida school administrators said Tuesday that they never felt an inkling of alleged price fixing in multimillion-dollar contracts they signed with milk distributors and processors during the past several years.

"The state has requested these (milk-purchase) records for the last four years," said Betty Heiser, director of purchasing for the 90,000-student Palm Beach County School District. "We just turn them out and send them out."

8.65 million half-pints

Under a contract put out for bid last year, she said, the school district will spend more than \$1.65 million for 8.65 million half-pint cartons of milk supplied by McArthur Dairy Inc., a subsidiary of Chicago-based Dean Foods Products Co., one of seven national milk processors named as defendants in the antitrust suit.

State officials have slightly different figures. They show Palm Beach County schools spent \$1.275 million for about 8.5 million cartons of milk.

The figures vary because state officials, in a statement released Tuesday, explained that they represent unperfected "current or recent contracts now under investigation."

McArthur also provides milk this year to the 16,000-student Martin County School District, which had a contract last year with Borden. Martin County spent about \$165,000 for 1.1 million half-pints of milk in an unspecified current or recent contract, according to state records.

How Much For Milk

Here are the affected school boards and their approximate expenditures for milk under current or recent contracts.

| County | Approximate 1/2-pint purchases | Approximate cost |
|--------------|--------------------------------|------------------|
| Palm Beach | 8.5 million | \$1,275,000 |
| Martin | 1.1 million | 165,000 |
| St. Lucie | 4.2 million | 630,000 |
| Okeechobee | 648,000 | 97,200 |
| Indian River | 1.2 million | 180,000 |
| Dade | 40.0 million | 6,000,000 |
| Broward | 15.5 million | 2,375,000 |

Source: Florida Department of Legal Affairs, Office of the Attorney General

Velda Farms, which has a contract with the St. Lucie County School District, and Borden, which provides milk to Okeechobee County schoolchildren, also were named in the antitrust suit along with four statewide distributors of milk and dairy products.

"We just haven't about the (lawsuit) yet," said Eric Blum, a lawyer and general counsel of Dean Foods. "It's premature to comment."

Local officials not a part

State officials stressed that officials of local school districts apparently were not involved in the bid-rigging scheme.

"We've always noticed that it's a close price (between companies bidding for the milk contract), said Heiser of Palm Beach County schools. "But they never seemed unfair. We were looking for the best price. McArthur was the best

price for us."

She said the district pays McArthur about 15¢ cents each for 4 million half-pint cartons of whole milk, 4 million half-pint cartons of chocolate milk and 425,000 half-pint cartons of low-fat milk. The milk is sold to students for 25¢ cents, Heiser said.

St. Lucie County schools, with an enrollment of about 16,500 students, expects to pay about 15¢ cents each for about 1.1 million half-pint cartons of Velda Farms milk, said district spokesman Mark Molina.

He said the state had been requesting milk purchase records for the past 3½ years. A total of \$630,000 for 4.1 million cartons of milk was cited by the state ap-

parently a reference to contracts for several past years. Molina said he said the figure might include parts of years as well.

'Don't feel ripped off'

At this point we don't feel ripped off, said Molina, noting that individual cartons of milk are sold to students for 25¢ cents. When bids come in, they look normal. It's hard for me from my view to determine bid-rigging.

State officials indicate that current or recent contracts targeted in Martin County schools call for the payment of about \$185,000 for 1.1 million half-pint cartons of milk.

"I know there had to be some thing going on," he knew the state Attorney General's office had been looking at the records, said Carol Montal, the Martin County school district's food service coordinator. "I've worked in Palm and Martin, and there's always been formal bidding. I was not aware of any irregularities."

In Okeechobee County, where about 5,500 students are enrolled, the school district will spend about \$160,000 for about 650,000 half-pint cartons of Borden milk.

Under Martin, which switched from Borden to McArthur milk (Okeechobee Flip-flopped this year from McArthur to Borden).

McArthur has received the bid allocation for the past several years, but we went with Borden this year, said Superintendent Danny Molina, who could not provide figures.

State sues 7 dairies, charges price fixing

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has collected \$10 million through their bid-rigging, Butterworth said.

\$30 million sought

Butterworth said the state would seek \$30 million in damages to be reimbursed in school districts if the lawsuit is successful.

Dairy companies' representatives usually meet in person to match production estimates in markets in Florida, said Frank Storkin, director of the Attorney General's Economic Crimes Division and head of the bid-rigging investigation.

A company that needed to sell 1 million cartons of milk would be assigned a school district and had a certain price and all other companies would agree in bid half a cent to a penny more than that price, ensuring the company would receive the contract, Storkin said.

The process was repeated as companies traded school districts, meeting and matching their production and the schools in fit their marketing needs.

Computer detects pattern

An extensive computer review of bid prices through Florida's 67 school districts revealed the pattern, officials said.

The investigation began about two years ago, but most of the evidence has been collected in a five-month review of school district and company records, said Jerome Hoffmann, chief of the antitrust section of the Attorney General's office.

Butterworth's suit claims that the company's dates in the late 1960s or early 1970s. Actual price fixing and bid-rigging began no later than 1978 and continued at least through 1987, the suit says.

It was a very sophisticated operation. There is no way that school board people would have had any suspicion, Storkin said.

According to court documents, the 32 companies involved in the case spent nearly \$28 million a year for

milk. The price for a carton of milk in Florida's schools ranges from 13¢ cents to 17¢ cents, according to authorities.

Criminal charges possible

Law enforcement officials refused to discuss criminal prospects in specific counties, saying criminal charges might be filed.

Asked whether criminal charges were likely to be filed in the case, Butterworth replied, "This investigation is not over yet."

Spokesmen for the dairy processors and distributors named in the lawsuit generally declined to comment.

But representatives of two companies denied any wrongdoing.

"We know that the investigation was under way and have cooperated fully with Florida authorities," said Kraft spokesman Scott Horne. "Our marketing is a normal business of supplying to Kraft employees and we plan to defend ourselves vigorously."

Two companies, Kraft and Pet Inc. of St. Louis, have sold their milk divisions to other companies. Kraft sold its Florida milk operations marketed under the Sealab label to Borden in 1984. Horne said.

Milk still is sold in Florida under the Pet label by Land-O-Lake Inc. of Johnson City, Tenn., said Les Landis, director of communications for Pet. The Tennessee firm bought Pet in December 1985, Landis said.

During the time that we did own the business, we certainly had no knowledge of any wrongdoing taking place in the milk business in Florida or anywhere else, Landis said.

A former official of the Smith Land Corp., which is named as a defendant in the attorney general's lawsuit, refused to comment on the allegations.

"We haven't seen the lawsuit yet and we I can't tell you anything," said Jerry Rasmussen, a lobbyist for the Florida Dairy Products As-

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EXAMPLES OF COST MISCHARGING

Contractor Billed EPA \$600,000 in Excessive Costs.

Several Contractors performing emergency cleanup actions under the Superfund program overcharged the EPA more than \$600,000 by billing at rates that were excessive compared to those charged on similar contracts. The problem of excessive rate charging was chronic because contractors were employed on an emergency basis before negotiation of terms. We recommended that proper contracting and procurement controls be implemented and enforced.

Grantee Final Construction Grant Claim Includes Over \$1.4 Million of Ineligible or Unapproved Costs that were Sustained

The West County Agency of Contra Costa County claimed \$3,732,990 of questionable expenditures for the construction of a wastewater treatment facility including over \$1 million previously disallowed by EPA and \$1,226,335 of technical services costs which exceeded reasonable amounts. overstated actual indirect costs were outside of the approved project scope, and were applicable to the ineligible portion of the construction.

The Regional Administrator, Region 9, sustained \$1,449,621 Federal share of the costs questioned or set aside and deferred \$449,916 pending a technical review of a contractor's settlement claim.

\$2.4 Million Disallowed on Merced, California, Sewage Grant

The city's finance department customarily processed construction and engineering claims without first determining if they were eligible project costs. As a result, the City of Merced claimed \$1,586,059 of unallowable costs.

We also set aside \$831,491 of interest that the grantee earned on a duplicate claim for ineligible construction costs and \$136,650 in claims relating to the plant's landscaping to determine its eligibility.

We recommended that the Regional Administrator (1) disallow and recover Federal share reimbursements made to the grantee, (2) evaluate the set-aside costs, and (3) ensure that the Public Works Department review claims for grant reimbursement before submission to the State Board and EPA.

The Regional Administrator sustained \$2,463,793 of the questioned and set-aside costs.

False Claims and Kickback Conspiracy in Superfund Cleanup

In our first Superfund related prosecution, the Environmental Management Corporation (EMC), Utica, Michigan, and three of its owners/officers pled guilty to conspiring to defraud the Government. EMC allegedly submitted false manifests and site receipts during the 1982 Superfund cleanup of the Liquid Disposal, Inc., site. During our investigation haulers admitted driving only half-full trucks that EMC manifested as full and a waste disposal firm admitted paying EMC a \$25,000 kickback for receiving its business. Each defendant was fined \$5,000 and sentenced to 4 months in prison. EMC was fined \$10,000 and placed on five years probation.

EPA Regional Administrator Disallows Over \$5.5 Million on Philadelphia Grant

The City of Philadelphia claimed about \$15 million of construction charges that it withheld from the contractor pending a settlement on financial damages involving soil and waste removal. We referred for Agency review \$7.3 million of costs that were not within the scope of the

project grant. An additional \$1.7 million of costs were also referred for Agency review pending the submission of supporting documentation by the grantee.

We recommended that the Regional Administrator, Region 3, not participate in the Federal share of questioned costs, determine whether EPA should participate in the cost referred for review, and recover all applicable amounts due EPA.

The Regional Administrator, Region 3, sustained \$5.53 million the costs questioned and referred for review.

Extensive Overcharges Identified in Cleanup at Drum Recycling Facility

EPA awarded \$1.3 million in contracts for emergency cleanup following a fire at the General Disposal Company, a paint and chemical recycling facility in Santa Fe Springs, California. The contractor, IT Corporation, did not maintain an adequate accounting system for the identification of individual project costs. The contractor billed EPA \$163,000 for ineligible costs and \$341,000 for questionable costs including duplicate payments to vendors, charges in excess of actual material and equipment rental costs and full cost for items which the contractor received vendor discounts.

We recommended that the ineligible costs be disallowed, the questioned costs be reviewed to determine eligibility and that IT Corporation be advised that their accounting system is inadequate for EPA contracts.

Litigation and Budget Overruns Result in EPA Sustaining \$638,674 of Ineligible and Unsupported Costs

The Gates-Chili-Ogden Sewer District, New York, claimed over \$1 million of ineligible legal, settlement, and construction costs on an EPA grant resulting from litigation with its construction contractor which delayed the expansion and upgrading of a treatment plant by 3 years. We also set aside over \$1 million in budget overruns and unsupported costs.

The Regional Administrator, Region 2, sustained \$638,674 of the Federal share of questioned and set-aside costs.

Grantees Overcharge \$3.9 Million For Waste Water Treatment Projects.

In separate grant awards, Dade County Florida, Delano, California, and Houston, Texas, charged the Waste Water Treatment Works Construction Grants Program \$2.4 million, \$1.1 million, and \$400,000 respectively for ineligible costs beyond the scope of the project or unapproved change orders. We recommended recovery of these costs.

Theft and Misuse of Government Property, False Travel Claims

Based on allegations from an EPA laboratory director and complaints from a private citizen, we initiated an investigation of a scheme by a former EPA employee to steal gasoline purchased with a Government credit card, misuse a government vehicle, and falsify travel vouchers.

Mr. Finck would drive as much as 800 miles a day to return home and remain there for 24 hours while supposedly on a continuous travel status for which he falsely claimed expenses.

Steven J. Finck admitted stealing 120 gallons of gasoline and falsifying 25 percent of his travel vouchers by an additional quarter of a day to be paid additional per diem. He resigned on August 9, 1985.

Mr. Finck was indicted on October 15, 1985, on three counts of false claims, one count of false statements and one count of theft of Government property.

EPA Employees Suspended for Conduct Violation

Two EPA employees, a branch chief and an inspector, were suspended without pay for 30 days for violating the EPA standards of conduct. During the investigation, both employees admitted that the inspector obtained bags of fertilizer from sites that he officially inspected and provided them to the branch chief, who had requested them for his personal use. They also admitted using Government vehicles to transport the fertilizer to the branch chief's residence. In addition, the inspector admitted receiving meals, home and garden products, and "bike-a-thon" donations from companies he inspected.

Former EPA Purchasing Agent Prosecuted for Self-Dealing

Richard Crossgrove, a former EPA employee, pled guilty to a criminal information on June 24, 1986, charging him with performing official Government acts to affect his personal financial interest.

The information charged that from May 1982 to September 1985, Mr. Crossgrove, while working as a purchasing agent for the EPA in Pensacola, Florida, personally and substantially participated in procurement of materials for EPA from Applied Science Distributors (ASD), a company which he founded, operated, and had a financial interest in.

During the investigation, Mr. Crossgrove admitted that he founded ASD in the name of his then-14-year-old stepdaughter who had a different last name because "the Government looked more favorably on minority-owned business" and he did not want the Crossgrove name on ASD's records. At first, Mr. Crossgrove collected about 10 percent of the price as profit, but he eventually increased the profit margin to about 50 percent. Mr. Crossgrove estimated that ASD's profit from sales to EPA (its only customer) totalled about \$12,000 to \$15,000.

On August 8, 1986, Mr. Crossgrove received a suspended prison sentence, 5 years probation, a \$3,000 fine, and a special monetary assessment of \$50. Mr. Crossgrove resigned from EPA when he learned that the OIG would be investigating his activities.

EPA Employee Suspended for False Statements

An EPA secretary who submitted falsified documents to the EPA Personnel Office was notified on July 14, 1986, that she would be suspended from her job for 21 calendar days.

The suspension resulted from an OIG investigation during which the employee admitted signing her first and second level supervisors' names on rating forms she prepared for herself for upward mobility positions within the Agency.

Theft of Government Checks Results in Prosecutive Action

Blair J. Lyons, former employee, Accounting Operations Branch, Financial Management Division, EPA, pled guilty on August 28, 1986, to the charge of forging endorsements on U.S. Treasury checks.

During the investigation, conducted jointly by the EPA Office of Inspector General and the U.S. Secret Service, Lyons admitted stealing 19 checks worth over \$8,000 from the EPA Financial Management Division. He cashed and forged at least 14 of them before being apprehended.

Senior Official Reprimanded for Conducting Law Practice on Government Time

An EPA employee was given a written reprimand for conducting a private law practice using Government time and property, including office premises, telephone, a Lexitron word processor, and accompanying diskettes.

During the investigation, initiated by a complaint to the OIG Hotline, 21 Lexitron disks in the employee's possession were inspected by the OIG. Two contained material exclusively related to his law practice; the other 19 contained a combination of Government work and personal legal documents. Some of the legal documents listed the employee's EPA telephone number as his private law office telephone.

The written reprimand directed the employee not to misuse Government equipment, supplies, office space, telephone, or secretarial support in the future. A copy of the reprimand was entered into the employee's official personnel file.

Project Officials Embezzle Almost \$65,000 of Grant Funds

William H. Yeary, a Bell County, Kentucky official along with Elmer Cleveland, a former EPA project officer, pled guilty on July 17, 1986, to charges of embezzling grant funds and filing fraudulent travel vouchers totalling nearly \$65,000. Shortly after being hired by Bell County to manage a \$410,000 EPA grant, the county official began systematically converting grant funds to personal use. In carrying out the scheme, he terminated the bookkeeper, developed a close personal relationship with the EPA project officer responsible for

The participants attempted to cover up the scheme by discouraging audits and destroying or altering records. However, based on the strength of allegations, an OIG auditor worked effectively with the FBI and independent third parties such as banks, credit card companies, and telephone companies to reconstruct enough records to prove fraud.

Mr. Yeary and Mr. Cleveland were each sentenced to 3 years imprisonment on September 25, 1986. All but 60 days of Mr. Cleveland's sentence was suspended. However, he was also fined \$1,000 and ordered to perform community service while on probation.

This case, developed by the Office of Audit in response to a direct request by the FBI, is particularly important to EPA since it will be given widespread publicity to deter future schemes.

monitoring the grant, and used a facsimile device to forge his supervisor's signature on checks, assuming complete control over all grant funds. He substantially increased his salary and converted portions of cash travel advances to personal use. He also used grant funds to pay for a week-long vacation in Gatlinburg, Tennessee, extensive personal phone calls and other personal entertainment.

The EPA project officer played a more passive role in the scheme and benefitted to a lesser extent. During a 2 1/2 year period, he travelled extensively with the county official in connection with the project. To keep the EPA project officer from blowing the whistle on the scheme, the county official used grant funds to pay for the EPA project officer's meals, drinks, golf fees, and occasional motel rooms. The EPA project officer filed fraudulent travel vouchers for reimbursement of these same expenses.

Falsification of Employment to Receive Unemployment Benefits

In August 1984, a match of unemployment benefit recipients of the California State Employment Development Department with EPA employment roles identified several EPA employees who may have simultaneously received unemployment benefits while employed by EPA. A subsequent investigation determined that May Kei Wong, a former part-time clerk for EPA, received \$1,545 in unemployment benefits by falsifying her employment status with EPA. On September 20, 1985, May Kei Wong admitted falsifying documents to receive the unemployment benefits and agreed to make full restitution. May Kei Wong was charged with making false statements on September 27, 1985.

Embezzlement of Government Funds

An unannounced audit of an EPA imprest fund by regional staff on March 30, 1984, revealed a \$3,343 shortage in the fund entrusted to Vertie Lee Rogers, an EPA travel clerk and cashier. During a subsequent investigation by the OIG, Rogers admitted embezzling the money. Rogers resigned from EPA effective April 6, 1984, and made restitution to the imprest fund for \$3,343. Vertie Lee Rogers pled guilty to the charge and was sentenced to two years probation and ordered to perform 200 hours of community service.

Perjury, False Statements

A former EPA consultant, David B. Twedell, was sentenced on January 23, 1984, to one year in prison after pleading guilty to fabricating his academic credentials. As a geologist for JRB Associates, McLean, Virginia, Twedell supervised test drillings at Love Canal and other hazardous waste sites and appeared in court as an expert witness for the Government while working on a number of major EPA projects between December 1979 and November 1981. He claimed to have a Ph.D. and a B.S. in geology from the University of Houston where, in fact, he was dismissed for academic failure within only a few semesters.

Sewer Grout Supplier Convicted of Selling Underweight Bags of Grout

Alan Blane Grant and his company Polymer Chemicals Inc. of Atlanta Georgia pled guilty on September 24 1987 to conspiring to defraud the United States by selling underweight bags of chemical grout to sewer contractors and making false statements on U S Government forms regarding the origin of the grout.

From 1981 to 1987 Polymer Chemicals was in the business of mixing and selling Chem G-9 acrylamide grout, a waterproofing sealant for sewer lines. Investigation revealed that Polymer Chemicals short weighted bags of Chem G-9 grout used by contractors on EPA and other federally funded sewer rehabilitation projects thereby risking compromise of the sealant's effectiveness under certain conditions.

Polymer Chemicals also falsely represented to EPA Department of Defense and other contracting officials as well as to insurance carriers, that it was an importer, warehouse distributor, wholesaler, and reshipper of Chem G-9 grout manufactured in England, whereas in actuality Polymer Chemicals imported the chemical components and mixed them in the United States to create the grout.

Inspector and Company President Indicted for Fraud on Sewer Project

Ronald B. Connelly, President of REO Construction Company and Marlon L. Robinson, inspector with McClendon Engineering Company, were indicted by a Federal grand jury on August 24 1987 for submitting false statements in connection with an EPA-funded sewer rehabilitation project. The grant provided \$1,184,000 for testing, repairing, and replacing the sewer lines of the town of Shubuta, Mississippi.

The investigation determined that claims were submitted for over one hundred repairs that were not performed. Connelly was charged with making false statements that he repaired or replaced numerous sewer lines. Robinson was charged with making false statements that he inspected various sewer lines and found that they had been repaired or replaced according to specifications.

Twenty Five Plead Guilty in Emissions Testing Conspiracy

A major Orange, California laboratory which tested air emissions for imported "gray market" cars and 24 individuals who were indicted in an emissions testing conspiracy in March 1987 pled guilty to those charges in Los Angeles on September 4 1987.

The laboratory cheated on its testing procedures and falsified and fabricated test results to EPA on the gray market cars including Ferraris, Rolls Royces, Mercedes-Benzes, Porsches, and BMWs.

- Joseph D. Krueger and Insulation Specialty Company, Inc., of Cuyahoga Heights, Ohio, were debarred for three years on October 4, 1984. An OIG investigation determined that during improvements to a wastewater treatment plant, Krueger and his firm had substituted aluminum pipe jacketing for the more expensive stainless steel jacketing specified in the contract, and that they had billed the Northeast Ohio Regional Sewer District at the higher price. Upon discovery of the substitution, the materials were replaced at contractor expense. The project was funded by EPA.

False Photos Expose Gray Market Dealer to Indictment

Sunbelt Auto Imports Inc. of Houston, Texas and its vice president Floyd Redale Carney of Eustis, Florida, were indicted on February 27 1987 for taking part in a gray market scheme of importing cars that did not meet Federal emission and safety standards.

A joint investigation by the EPA Office of Inspector General and the Department of Transportation (DOT) revealed that Carney allegedly falsely certified to EPA and DOT that certain modifications were performed on gray market vehicles to meet Federal emission and safety standards. The certification process requires the car importers to send photographs of the modifications performed on the vehicles to EPA and DOT. The indictment charges that Carney and Sunbelt established a file of duplicate photos of properly

modified items on the imported cars. Between December 1982 and February 1984, the defendants allegedly submitted false photographs to receive compliance certifications on the vehicles.

Construction Company Managers Indicted for Fraud on Sewer Project

William B. Kruse, Project Manager/Supintendent and William F. Jordan, Project Foreman, and Charles B. Bryon, Project Foreman, all of Gates and Fox, Ltd., construction company, were indicted on June 27 1986. The indictments were for false claims, false statements, and mail fraud in connection with a \$1.4 million EPA-funded contract with Gates and Fox, Ltd. for 19,000 feet of sewer pipeline in the City of Corning, California.

The contract specifications required that the pipeline be surrounded with rock over the entire length of the project. This rock "envelope" was needed to provide support to the sewer conduit and to prevent cracking and collapse of the pipeline. The indictment charges that as part of their scheme to defraud, the defendants ordered that pipeline be covered with native soil rather than with the layer of rock called for in the contract that the defendants allegedly regularly employed "spotters" at the job site who were instructed to alert the pipeline construction crew whenever the contract inspector approached the area where native soil was fraudulently used, and that the defendants ordered that a layer of rock be placed over designated sections of the pipeline that might be subject to observation, thereby making it appear as if the entire pipeline had been properly back-filled. The false claim, false statement, and mail fraud violations allegedly occurred as the defendants falsely stated and claimed that the project was completed according to specifications and used the mails to fraudulently obtain payment. The deficient construction which could have caused the failure of the pipeline was subsequently corrected by the construction company at a cost of \$300,000. On August 26 1986, Bryon pled guilty to making false statements.

Consulting Engineer Indicted for Bilking Grantee Out of \$253,000 on Sewer Rehabilitation Work

Samar Chatterjee, president of Universal Engineering Services Inc. and AES Engineers Inc. in Willow Springs, Illinois, was indicted on August 31, 1987, for conspiracy, mail fraud, and making false statements in connection with consulting work he did on the EPA-funded South Stickney, Illinois, Sewer District sewer rehabilitation study.

Chatterjee was arrested when indicted and held on a \$1.4 million cash bond. Prosecutors said he was a flight risk because of his extensive financial interests in his native India.

The indictment charged Chatterjee with submitting false testing data concerning sanitary sewer connections, flow gauging, manhole inspections and sewer survey reports to EPA and the Metropolitan Sewer District of Greater Chicago. In addition, Chatterjee received EPA grant funds of over \$200,000 for work that he allegedly did not perform.

Chatterjee's indictment resulted from a 3-year investigation into allegations of financial fraud in the South Stickney Sewer District. The investigation was conducted jointly by the EPA Office of Inspector General, EPA Office of Enforcement and Compliance Monitoring, and the FBI.

Conspiracy, False Statements, Mail Fraud

David Wirt, his wife Judith and their son, Gordon, owners and executive officers of Municipal and Industrial Pipe Services (MIPS), pled guilty on January 13, 1984, to defrauding the government on sewer projects. David was sentenced to 8 years in prison. Gordon and Judith were given prison terms of 33 months and 6 months respectively. Each was fined \$10,000. The 47 count indictment charged the Wirts with a 10-year, \$8 million scheme to defraud the Federal government on sewer maintenance projects by failing to perform tests and repairs that they were paid to perform while they distorted test results and fabricated progress reports. The scheme involved several states and three foreign countries.

The MIPS investigation began in October 1981, after two former MIPS employees reported to city officials in Marietta, Georgia, that David Wirt was defrauding the Federal government on an EPA sewer rehabilitation project by deliberately pinching test hoses and failing to use grout in sealing sewer lines. At the time they were hired, Wirt had told the employees that the sewer rehabilitation business "was just a scam anyway."

When evidence showed that about half of the company's contracts were with U.S. military installations, including several foreign bases, the Inspector General's office requested assistance from the Defense Criminal Investigative Service of the Department of Defense.

Rehabilitating a sewer pipe involves cleaning by high-pressure water jet, followed by television inspection with remote cameras drawn through the pipe from one manhole to the next by cable. Each joint is air-tested for leaks, and leaking joints are sealed with two liquid compounds that, when combined, gel into a grout substance. Televising, testing, and sealing are accomplished from inside a van parked near one of the manholes. City inspectors monitor these procedures while sitting beside the TV operator in the van.

Wirt claimed to have sealed defective sewer pipe joints with grout when none was applied by installing hidden switches in company's television inspection trucks to re-route grout back into the truck tank while the meter registered it as going to seal sewer pipe joints.

Wirt manipulated his contacts whenever possible to provide for payment according to the number of pipe joints found to be defective. His main effort thereafter was to thwart inspection efforts—by keeping inspectors off the trucks and "blitzing" job sites with more TV trucks and crews than there were inspectors to monitor them. He spread out his trucks and crews as far as possible over the project, keeping inspectors in travel status between unfaking equipment breakdown when inspectors approached the unit, and devising strategies to make the inspectors extremely uncomfortable in the TV trucks.

When these and other tactics failed, repair crews and Wirt himself at times resorted to intimidation of the inspectors, sometimes threatening violence, physical injury or lawsuits.

To corroborate the testimony of former employees, sewer pipes were dug up at Air Force bases in Mississippi and Texas and at an EPA-funded project in Moultrie, Georgia. Analysis of pipe samples at EPA's National Environment Investigations Center in Denver showed that in places where grout was said to have been applied, there was actually little or no grout at

False Claims

The former city engineer of Moultrie, Georgia, was sentenced on September 15, 1983, to 3 years in jail, a \$10,000 fine and 2 years probation after pleading guilty of conspiring to approve payments of \$90,000 based on false claims for an EPA-funded project. The city engineer approved payments for raising and replacing manhole covers and pavement cleaning, inspecting, testing and grouting of sewer pipe joints without the work being performed. In return, the engineer received a motorcycle from the contractor.

• Environmental Technology of America, Inc., of Wilbraham, Massachusetts, and its president, Norman F. Smith, were debarred for 3 years on February 23, 1987, following Mr. Smith's conviction for mail fraud in Orlando, Florida, and on his plea of *nolo contendere* to a charge of forgery in Hartford, Connecticut. Mr. Smith had charged the State of Florida for chemical tests supposedly performed for him by an environmental testing laboratory in Chicopee, Massachusetts, that were not actually performed.

JACK ANDERSON and DALE VAN ATTA

NIH Runs Research on Blind Faith

The National Institutes of Health gives away more than \$5 billion a year for research. But whether that money is well spent is anybody's guess. For the most part, NIH blindly trusts that the money went for credible research.

Rarely does NIH challenge the integrity of prestigious universities or their esteemed scientists. The trust runs so deep that only one person on the NIH staff is assigned full time to investigate allegations of fraud.

Walter Stewart and Ned Feder, two NIH scientists, are scheduled to testify April 12 before a House Energy and Commerce subcommittee chaired by Rep. John D. Dingell (D-Mich.). They plan to tell the subcommittee that research is too often neither checked nor challenged. Feder and Stewart have long urged scientists to take a more active role in ensuring the quality of research.

"The peer review system does not pick up fabricated work," Stewart told our associate Jim Lynch. "You can get away with murder for a pretty long time."

Examples of questionable research likely to be studied by the oversight and investigations subcommittee include these cases, which have been detailed in medical journals:

- A blue-ribbon committee at Harvard in 1982 defended the research of scientist John Darcee, who had published his findings on heart medicines while at the university's medical school. Almost all of Darcee's writings, including more than 100 articles, were later found by NIH to be fabricated. Some of the information was ridiculous on its face, like the 52-member family Darcee invented for his

research. One of the men in that family was said by Darcee to have fathered his first child at the age of 8 and his second at age 9.

- University of Wisconsin biochemist Hector DeLuca allegedly pirated the work of a colleague to conceal defects in his patent for producing a vitamin D derivative. The patent is now more than 15 years old. Before the allegations against DeLuca recently came to light in a lawsuit over the patent, he had been mentioned as a nominee for the Nobel Prize. DeLuca contests the charges, and the university is investigating the matter.

From 1982 to 1987, NIH found evidence of misconduct in about 15 of 100 reported allegations of fraud. Investigators for the oversight and investigations subcommittee have determined that the number of abuses reported is reduced by an NIH system that tends to protect the offending scientist and put the whistleblower on the defensive.

If an allegation of fraud warrants investigation, NIH tells the university where the research is being conducted. The university then investigates, a process that sometimes covers up rather than exposes fraud. If NIH still smells a rat, it appoints an investigative panel. But that panel is staffed by scientists who are hesitant to lower the ax on their peers.

Even if a scientist is implicated in fraud, the evidence can disappear, making it hard to prove that the scientist deliberately doctored the research. In 1979, one drug researcher under investigation swore that all his data was lost when his rowboat flipped.

Contract Lab Program

Description Of Selected Prosecutive Actions

Below is a brief description of some of the prosecutive actions which occurred during the reporting period. Some of these actions resulted from investigations initiated before October 1, 1990.

Connecticut Company Backdated Results, Used Unapproved Lab

A Connecticut company, YWC Inc., pled guilty in December 1990 to two charges of making false statements to EPA and was fined \$500,000. EPA's contract with YWC required them to analyze water samples within seven days of receipt and soil samples within 10 days. YWC's York Laboratories Division facility in Monroe, Connecticut, was an approved CLP site. YWC was charged with backdating over 60 analyses and using a then-unapproved laboratory at Whippany, New Jersey, to do the analyses.

Superfund Contract Laboratory Program Investigation

The Office of Investigations has a major investigative initiative underway within the Superfund program, directed at fraud in the Contract Laboratory Program (CLP). Laboratory analyses under the CLP are the empirical basis for the entire Superfund program. Based on testing for the presence of hazardous chemicals by these laboratories, the Superfund program decides which cleanups to initiate and how to carry them out. Fraudulent analyses could result in a danger to the public health and safety as well as the unnecessary expenditure of cleanup funds. In addition, fraudulent analyses could hinder the Department of Justice's efforts to collect the cost of cleanups from the responsible parties.

The following five actions resulted from the contract lab investigations.

Missouri Lab Charged with False Test Data

Metstrane, Inc., Earth City, Missouri, and two of its former officers, Dr. Carol Byington, Executive Vice President, and Kenneth Baughman, Vice President, have pled guilty to submitting false statements to EPA under the CLP. It is alleged that the pesticide analysis for certain EPA samples were not performed in compliance with the protocol required under the EPA contract. Specifically, laboratory personnel allegedly manipulated results for calibration and check standards so that they showed that a group of environmental sample results were fully compliant with protocol criteria when, in fact, they were not.

Testing Equipment Allegedly Not Calibrated

Jayant Shringarpure, former manager of the Gas Chromatograph/Mass Spectrometer (GC/MS) laboratory at EAL Corporation (now known as TMA/Norcal), Richmond, California, was indicted on March 29, 1991. Shringarpure is alleged to have directed employees at EAL to perform GC/MS analyses of samples without first tuning and calibrating the GC/MS equipment as required by the EAL contract with EPA. Shringarpure is alleged to have also directed GC/MS operators to make copies of previously generated tuning data, so this data could be used as part of the documentation submitted to EPA for other GC/MS analyses. EPA officials estimate the loss to the Government at \$200,000.

California Lab Backdated Analyses

In another case involving fraud and abuse within EPA's Contract Laboratory Program, six former employees of the Environmental Chemistry Laboratory of the Science Applications International Corporation (SAIC), La Jolla, California, have pled guilty to charges of making false statements to EPA, aiding and abetting the making of false statements to EPA, and aiding and abetting the conversion of Government money. SAIC contracted with EPA to perform analysis on samples taken from Superfund toxic waste sites in order to (1) determine the amount and identity of the toxic chemicals, (2) establish priorities among sites so that the most dangerous sites are cleaned up first, and (3) help in identifying the parties responsible so that reimbursement for the cleanup costs can be obtained.

In the contract between SAIC and EPA, EPA required that volatile organic analyses be performed within ten days, in order that certain chemicals would not dissipate. Penalties

were assessed for lateness. In addition the contract required that sample analysis equipment be tuned and calibrated every twelve hours to insure accuracy. The joint investigation by the EPA OIG and the FBI uncovered that backdating of sample test results occurred in order to avoid the penalty. Also, the manipulation of the sample analysis equipment test data was performed to fraudulently reflect the accuracy of analysis equipment.

Duo Allegedly Provided Dirty Test Containers

Anita C. Rudd, Marvin W. Rudd, and I-CHEM Research, Inc. of Hayward, California, were indicted November 30, 1990, by a Federal grand jury on charges of conspiring to make false claims to EPA. Marvin Rudd is also charged with one count of using false documents.

From June 1983 until December 1987, I-CHEM was EPA's sole supplier for contaminant-free sample containers used to collect site samples for analysis and evaluation by the Contract Laboratory Program. The indictment charges that I-CHEM and the Rudds conspired to make false claims to EPA for providing contaminant-free sample containers under contract. It is alleged that I-CHEM shipped sample containers to authorized EPA requesters without actually performing the required quality control testing on the containers, notwithstanding certifications by I-CHEM to that effect.

Civil And Administrative Actions To Recover EPA Funds

Investigations and audits of the Office of Inspector General provide the basis for civil and administrative actions to recover funds fraudulently obtained from EPA. Through the Inspector General Division of the Office of General Counsel, the OIG uses a variety of tools to obtain restitution. These include cooperative efforts with the Department of Justice in filing civil suits under the False Claims Act, the Program Fraud Civil Remedies Act, and other authorities, working with grantees using their own civil litigation authorities, invoking the restitution provisions of the Victim and Witness Protection Act during criminal sentencing, using the Agency's authority to administratively offset future payments and to collect debts, and negotiating voluntary settlements providing for restitution in the context of suspension and debarment actions.

Civil and administrative actions to recover funds usually extend over several semiannual reporting periods. Progress is being made on several such matters.

Contract Lab Operator Agrees to Pay \$750,000

Rov F. Weston, Inc. of Lionville, Pennsylvania, in response to a civil action filed by the Department of Justice under the False Claims Act, has paid the Government \$750,000. The payment is part of a consent judgment arising from charges that the company submitted false claims for payment.

As part of Superfund, EPA has established a contract laboratory program in which EPA contracts for analytical services on material from Superfund sites. Weston obtained such a contract in June 1987 to perform certain laboratory work through one of its divisions, Weston Analytics, at its laboratory in Lionville. The contract required Weston to perform tests on soil and water samples. One test, volatile organic analysis, had to be performed on each sample within ten days of receipt to ensure accurate results. According to the complaint, over the course of a year, Weston Analytics failed to complete certain volatile organic analyses on time, concealed this failure by backdating its testing instrument, and then fraudulently billed EPA for these tests. As a result, some of the results submitted to EPA were unreliable, and EPA's responses to environmental hazards could have been affected.

In addition to the payment of \$750,000, Weston agreed to withdraw voluntarily from certain kinds of laboratory work at the Lionville facility for a period from 4 months to a year, subject to EPA's satisfaction with the compliance program. Weston instituted in response to the Federal investigation.

The case is part of a national initiative by the Office of Inspector General into allegations of fraud, waste, and abuse by EPA's laboratory contractors under the Superfund program. The matter was referred to the OIG by EPA's Superfund program office.

EPA Recovers Over \$170,000 from New Jersey Bribe

On March 28, 1990, EPA entered into an agreement with the Cape May County Municipal Utilities Authority and the State of New Jersey to split up \$250,000 in restitution paid as a result of a bribery conviction involving the construction of the Ocean City, New Jersey wastewater treatment plant. Under the agreement, EPA will receive \$171,077, the Authority will receive \$60,674, and the State \$18,248. Carl E. Widell paid the restitution in connection with pleading guilty to bribing local officials to obtain construction contracts and change orders. EPA paid 75 percent of the costs of the project.

Superfund Contract Laboratory Program Investigation Yielding Formidable Results

The Office of Investigations has a major investigative initiative underway within the Superfund program, directed at fraud in the Contract Laboratory Program (CLP). Laboratory analyses under the CLP are the empirical basis for the entire Superfund program. Based on testing for the presence of hazardous chemicals by these laboratories, the Superfund program decides which cleanup to initiate and how to carry them out. Fraudulent analyses could result in a danger to the public health and safety as well as the unnecessary expenditure of cleanup funds. In addition, fraudulent analyses could hinder the Department of Justice's efforts to collect the cost of cleanups from the responsible parties.

Our initiatives in the CLP, which are very complex and time-consuming, to date have resulted in a civil settlement of \$750,000, which was reported in the last semiannual period ending March 31, 1990. During this period one indictment, reported below, was returned against a laboratory supervisor for providing fraudulent laboratory test results to EPA.

Contract Lab Supervisor Indicted

Dr. Vinh Tran, a former group leader of the Gas Chromatograph/Mass Spectrometer Unit at Weston Analytics, Lionville, Pennsylvania, was charged on July 30, 1990 with two counts of making false statements to EPA. Weston Analytics is a division of Roy F. Weston, Inc.

Dr. Tran had allegedly engaged in backdating laboratory analysis results of certain water and soil samples obtained from various Superfund sites by EPA and submitted to Weston for analysis. It is further alleged that Dr. Tran acted to conceal the fraud by a process known as "time travel" which involved setting back the computer clock attached to the Gas Chromatograph/Mass Spectrometer instruments to a date and time earlier than the actual date and time in order to meet sample testing requirements set by EPA.

As reported previously, Roy F. Weston, Inc. of Lionville, Pennsylvania, paid the Government \$750,000 as part of a consent judgment in response to a civil action filed by the Department of Justice under the False Claims Act.

Description Of Selected Prosecutive And Administrative Actions Concerning EPA Employees

The OIG investigates and reports information, allegations, and indications of possible wrongdoing or misconduct by EPA employees and persons or firms acting in an official capacity directly with EPA or through its grantees. In addition, the Senate Report of the Supplemental Appropriations and Rescission Act of 1980 states that appropriate administrative action is expected to be taken in cases where employees have acted improperly.

Employee Makes Restitution in Travel Fraud and FTS Telephone Misuse Case

An EPA employee at Headquarters in Washington D.C. entered into a Pretrial Diversion Agreement on May 31, 1990 with the U.S. Attorney's Office, District of Columbia. This agreement was reached after the employee admitted fraudulent obtaining \$1,450 in travel advances, accepting \$408 in collect telephone calls on a office telephone, and fraudulently obtaining \$185 claims for reimbursement applied for in the name of other employees. As part of the employee's offer to make full restitution in the amount \$2,021 and to perform 40 hours of community service, prosecution was deferred to 1/2 months after which the record would be expunged, the employee meets all the conditions of the agreement. The employee has already begun making restitution. E has begun action to remove the employee.

SUCCESS TECHNIQUES FOR LOCATING PROBABLE TROUBLE SPOTS
IN EMERGENCY RESPONSE CLEANUP SERVICES CONTRACTS (ERCS)

by Deirdre M. Tanaka

Divisional Inspector General for Investigations
Northern Division

INTRODUCTION

Auditors and/or project managers must be alert to potential fraud and abuse in every facet of cost reimbursement items, or with fixed prices, the quantity controlled items.

In pre-ERCS, contracts were all cost reimbursement type. In post-ERCS, most contracts are fixed price with some cost reimbursement types. Know what kind of contract you are reviewing. With a cost reimbursement contract everything is subject to fraud, however, with a fixed price contract only the part of the multiplier that is not standard is subject to fraud and should be reviewed.

WHAT TO DO

Look at entry/exit logs, both personnel and equipment. Check to see if different names are in the same handwriting or if the original signed logs are not in time sequence, or "lost."

Look at 1900-55s. Check to see who is signing them on behalf of the Government and the company. Is there a change in the way the company billed for certain items, i.e., from a total monthly cost to an hourly or per diem cost rate.

Look at invoices. Check to see the categories or items where the company is making large amounts of money. Is the company billing for items in categories inconsistent with common sense. For instance, most emergency cleanup is accomplished with rented equipment is this listed as subcontract equipment; is the lessor and location identified.

Look at manifests. Check the quantities billed, dates, drivers, and truck numbers. Are there inconsistencies in handwriting, or between the names on the entry/exit logs.

Compare daily pollution reports to the 1900-55s. Could the contractor have done what he said he did.

Compare the number of laborer and technician hours to the equipment hours billed during a certain period. Could the contractor have used this equipment.

SUCCESS TECHNIQUES FOR LOCATING PROBABLE TROUBLE SPOTS
IN EMERGENCY RESPONSE CLEANUP SERVICES CONTRACTS (ERCS)

Find out what kind of internal documents are maintained by the prime.

Find out through the company's insurance file what equipment is listed and what the initial equipment cost is.

Find out through corporate minutes or Dun and Bradstreet reports the names of companies the contractor has an interest in.

Look at entertainment or marketing expenses for EPA and TAT team members names.

Look to see who the company is keeping you away from. What was their position and what could they tell you if they were allowed to talk. In the EMC case the company told the auditors and investigators that the truck drivers had all moved away.

Find out the names of individuals who were responsible for submitting data for 1900-55s; or negotiating leases or provided laborers. Normally kickback arrangements or inflated cost arrangements are made by someone of at least managerial rank although the arrangement may be implemented by someone of much lower rank.

Do not make assumptions; let the contractor explain.

Always look at original records, if checks are provided, always check the reverse to determine if the named payee is the actual payee or if there has been a second endorsement.

Always check the general ledger to determine how much business the prime contractor was doing with the subcontractors prior to and subsequent to the cleanup. If there were any payments from the subcontractor to the prime contractor during the term of the contract or following EPA payment to the prime contractor this should alert you to potential kickbacks.

When you ask to see invoices, try to get the entire invoice file for that subcontractor so that you can determine if the invoices submitted are on the same form, in similar type and format to that previously submitted. Also check the invoice numbers to see that they are sequential for both private and cleanup business.

Some material is available free of charge or at a minimal cost, for example, flyash from power plants can be used as part of an earth cap at a cleanup site. The only cost should be transportation.

SUCCESS TECHNIQUES FOR LOCATING PROBABLE TROUBLE SPOTS
IN EMERGENCY RESPONSE CLEANUP SERVICES CONTRACTS (ERCS)

Some hazardous wastes are worth money to the disposers, for example, hypochlorinated wastes can be used to treat cyanide wastes, if the disposer treats private companies cyanide wastes he is willing to do what's necessary to get our wastes.

Some wastes can be converted to a non-hazardous waste on site through controlled chemical reactions. For example, isocyanates can be turned into a solid foam, and acids can be disposed into the sanitary sewer with the permission of the sewer district.

Proforma invoices are usually available on demand. Sometimes they are marked as a proforma or as a price quotation. Check a subs entire invoice file (both EPA, and non-EPA). to determine if there are differences between the subs actual paid invoices and the ones being presented to EPA to support Superfund charges.

If there are two or three prime contractors on the same site, determine if they are subbing to each other. Remember, their services are worth 5-15 percent more because of the handling charge if they arrange to work indirectly for each other rather than directly for the ERCS contractor or the Government.

Look to see if your subs have subs which more logically should have been direct subs. At each tier someone else adds a charge.

Be careful handling original documents such as checks, invoices, or 1900-55s. Investigators might have to subject the documents to forensic examinations, i.e., fingerprint or handwriting, to tie the documents to a particular employee.

It is very important that the auditor document where, when, and from whom he gets information. Sometimes incriminating documents will be subsequently destroyed and unless we can authenticate the documents, the copies will be inadmissible. The auditor should initial, sign, and date the documents.

SUCCESS TECHNIQUES FOR LOCATING PROBABLE TROUBLE SPOTS
IN EMERGENCY RESPONSE CLEANUP SERVICES CONTRACTS (ERCS)

Whenever you have a situation which you feel is suspicious, it is important to informally contact the DIGI as soon as possible. Following is some information which will probably be asked:

1. Who is the contractor, and what is his location.
2. Where was the cleanup.
3. What was the type and amount of the contract.
4. When was the cleanup started, when did it end and when was the final invoice submitted.
5. Who was the contractor's on-site representative, who was the contractor person responsible for submitting invoices and arranging for products or disposal.
6. What item(s) do you think presents a problem; how much did the item(s) cost.
7. If a subcontractor is involved, provide as many details about the name, location, and responsible official, as you have.

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FINANCIAL MANAGEMENT IN THE PUBLIC SECTOR

Published by

The Association of Government Accountants

SPRING 1986

Vol. XXXV, Number 1

The Auditor's Role in Detecting Fraud During Audits

Michael J. Binder

AUDITORS OFTEN FEEL NERVOUS and confused about their role in detecting fraud during audits, and it is easy to see why. The Securities and Exchange Act of 1933 put the burden of proof on the auditors, who were assumed to be either culpable or negligent in failing to detect a fraud. Even though the Securities Act of 1934 legally removed that burden of proof from the auditor, the courts have constantly been filled with actions against auditors, both with and without merit. Cases such as McKesson and Robbins in 1938, among the first major lawsuits against a CPA, in which the firm of Price Waterhouse and Co. settled out of court for \$522,402; and *United States vs. Benjamin*, in which criminal liability was assessed to the auditors, have caused many people to think that if something goes wrong, then it must be the responsibility of the auditors because they were making the audit. The profession has maintained for years that it cannot be held responsible for the detection of management fraud. The professional standards are written to protect the auditor from that responsibility.

However, the auditor's role in detecting fraud is vague at best, because it is based upon a subjective interpretation of the professional standards. But auditors working as part of Office of Inspector General organizations have begun to exercise a broader application of the professional standards to greatly increase their probability of detecting fraud. This is not to say that auditors of Inspector General organizations have a greater responsibility to detect fraud, but just a more comprehensive approach in applying abstract standards.

So let's look at how the professional standards define the auditors' role in detecting fraud and how the OIG auditors are applying those standards. The fourth General Standard for Governmental Auditing best illustrates this role. The standard is as follows:

"Due professional care is to be used in conducting the audit and in preparing related reports."

The American Institute of Certified Public Accountants (AICPA) states that:

"Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the examination."

The AICPA further states:

"The matter of due care concerns what the independent auditor does and how well he does it."

According to the General Accounting Office's yellowbook "Standards for Audit of Governmental Organizations, Programs, Activities and Functions," the "due care" standard does not imply unlimited responsibility for disclosure of irregularities or noncompliance. According to GAO, neither does it imply infallibility on the part of either the audit organization or the individual auditor. Rather, the standard imposes upon the auditor a requirement to be alert for situations or transactions that could be indicative of fraud, improper or illegal expenditures or operations, inefficiency, waste, or ineffectiveness. The standard does not require, according to GAO,

"... That the auditor give absolute assurance that no material impropriety exists; nor does it require that a detailed audit of all transactions normally be undertaken."

Audits are not primarily or specifically designed, and cannot be relied upon, to disclose errors or irregularities even though their detection during an audit may, in fact, occur. In performing any audit, the auditor is required to comply with generally accepted auditing standards, or in the case of the Federal, state, or public auditors performing audits for Federal agencies, to comply with GAO standards (which are based on generally accepted auditing standards). The responsibility of the auditor for failure to detect fraud arises only when such failure clearly results from failure

to comply with generally accepted auditing standards. This fact is affirmed by the professional standard for auditors regarding the detection of errors or irregularities, promulgated by the American Institute of Certified Public Accountants (AICPA). The AICPA uses the term *irregularities* to refer to intentional distortions of financial statements, such as deliberate misrepresentations by management, sometimes referred to as management fraud or misappropriation of assets, sometimes referred to as defalcations.

The AICPA's standard states that:

The subsequent discovery that errors or irregularities existed during the period covered by the independent auditor's examination does not, in itself, indicate inadequate performance on his part. The auditor is not an insurer or guarantor; if his examination was made in accordance with generally accepted auditing standards, he has fulfilled his professional responsibility."

This is not to say that the role of auditors is such that they have no responsibilities whatsoever for detecting and preventing fraudulent acts, but that their responsibilities are limited to the adherence of minimum standards and due professional care, both of which are often vague or abstract. With the passage of the Inspector General Act of 1978 and Congress' concern with fraud detection and prevention in Federal programs, the role of auditors in the Office of Inspector General of the Environmental Protection Agency, for example, has taken on new dimensions as it has for most auditors in Federal Offices of Inspector General. Highly vulnerable Federally assisted projects are now being identified by EPA's OIG and audits are being performed which concentrate on fraud-prone areas or areas which are susceptible to being abused. OIG auditors are now better trained to detect fraud and have considerably more knowledge of a project's vulnerability to fraud or abuse. Thus, prior to commencing a given audit, OIG auditors are alert to the fact that fraud and program abuse may indeed be disclosed during the audit. The use of computers such as in matching projects and cooperative effects with criminal investigators force are being used regularly by OIG auditors to do more to assist them to detect fraud.

However, this has not always been the case. It is important to keep in mind that the current emphasis on detecting fraud in Federally funded programs and Federal auditors' increased awareness of fraud detection techniques are of recent origin—coming about with the Inspector General legislation, and Congressional hearings on fraud in HHS programs and the earlier GSA contractor scandals. However, even today, while there is a growing "awareness" on the part of all Federal auditors regarding fraud detection, the auditor is not responsible for detecting all fraudulent acts, but, as always has been the case, is merely responsible for exercising "due professional care" in the conduct of the audit and preparation of the audit report. If an objective of audits was the detection of all fraud, then the cost of conducting audits would be prohibitive, and even then, one would not be assured of detecting all types of fraud, especially such matters as unrecorded transactions and collusive acts. But through the help of more aggressive training in fraud detection, expanded applications of computers and a close collaborative relationship with criminal investigators made possible by the Inspector General Act of 1978, OIG auditors are committed to significantly increasing their level of "due professional care." While this commitment does not change the auditor's responsibility for detecting fraud, it significantly improves the odds.

By introducing the use of new techniques, the OIGs could have a profound effect in establishing greater applications of "due professional care."

Thus the OIGs may be responsible for expanding the auditor's role in detecting fraud throughout the profession.

Michael J. Binder is an auditor with EPA's Office of Inspector General in Washington. A member of AGA's Prince George's Chapter, he holds BBA and MBA degrees from The George Washington University.